# Central banks and different policies implemented in response to the recent Financial Crisis

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# ABSTRACT

Rescue cases involving guarantees (contrasted with restructuring cases) during the recent Financial Crisis, have illustrated the prominent position which the goal of promoting financial stability has assumed over that of the prevention or limitation of possible distortions of competition which may arise when granting State aid.

The recent Financial Crisis has also illustrated how the traditional role of central banks has been extended to incorporate more innovative roles. The reduction of interest rates by central banks to all time lows – along with other unprecedented actions which have been undertaken by central banks, as evidenced by the recent Financial Crisis, have been regarded as „extensions of traditional methods of operation which have resulted in a new territory in which tools have been implemented in very new ways."

As well as providing an analysis of how the traditional role of central banks has evolved through the duration of the Financial Crisis, this paper attempts to highlight how far central banks and governments should intervene and how far distortions of competition should be permitted during periods of financial crises.



Key Words: competition, central banks, recapitalisation, stability, regulation, financial crises, fundamentally sound financial institutions, macro prudential, Basel III, systemic risk, supervision, liquidity, state aid, monetary policy

# Central Banks and Different Policies Implemented in Response to the Recent Financial Crisis.

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## A. Introduction

It is argued that competition assessments – whether carried out only by the competition authority or in conjunction with the financial sector regulator, are vital for state aid applications and many emergency measures which may have been established by governments.[2] Whether new regulatory procedures which are to be introduced will facilitate "meaningful competition assessments" to be made within the available time period during times of crises, constitutes a topic of controversial dimensions and such controversy is also acknowledged.[3]

Up till the 1980s, it was widely acknowledged that competition contributed to the deterioration of financial stability – intense competition was particularly considered to favour excessive levels of risk taking – hence contributing to higher risks of individual bank failures.[4] However it has been recently observed that "panic runs can occur independently of the degree of competition in the market."[5]

Certain views regarding contributory factors to financial crises and particularly financial instability, embrace criticisms of the monetary policies established by central banks. The standard argument advanced by critics of monetary policies during past financial crises, relates to the fact that "interest rates were kept too low for too long and that this created for investors, both an incentive and a possibility to take excessive risks."[6] A further criticism of monetary policy is attributed to the fact that investors are encouraged to believe that monetary policies will always bail them out in times of financial difficulties.[7]

Whilst the need to promote and maintain financial stability is paramount, safeguards need to be implemented and enforced to ensure that measures geared towards the aim of sustaining system stability (measures such as lender of last resort arrangements and State rescues) do not unduly distort competition as well as induce higher risk taking levels. This paper will draw attention to safeguards which have been provided by the Commission where approval is considered for the grant of State aid to financial institutions whose problems are attributable to inefficiencies, poor asset liability management or risky strategies. In a previous paper,[8] safeguards which are in place to

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[2] Organisation for Economic Cooperation and Development, "Competition and the Financial Markets: Key Findings" (2009) at page 10 <http://www.oecd.org/dataoecd/9/22/43067294.pdf>
[3] ibid
[4] See ibid at page 26
[5] ibid
[6] C Noyer, "Central Banks in the Financial Crisis" Bank for International Settlements Publications <http://www.bis.org/review/r090710a.pdf>
[7] Since „central banks would not lean against bubbles but have been prepared to clean up the consequences after they burst." See ibid
[8]Please particularly refer to section four of the paper (by the author) "Liquidity Assistance and the Provision of State Aid to Financial Institutions" (2010) Munich RePEc and SSRN Working Papers

ensure that competition is not distorted were considered under section four of the paper. Such safeguards, as considered in the paper, are applicable both to financial institutions whose viability problems are exogenously induced (and also related to extreme conditions which prevail in the financial market), as well as those financial institutions whose endogenous problems are related to inefficiency or excessive risk- taking. The paper also considered the rationale for the distinction between these institutions and concluded that financial institutions whose problems are attributable to inefficiencies, poor asset liability management or risky strategies should be accorded the same treatment as those whose viability problems are exogenously induced (and also related to extreme conditions which prevail in the financial market) as far as such „non fundamentally sound" institutions are considered to be systemically relevant.

Whether the distinction drawn by the Commission – with regards to the preferential grant of recapitalisation packages to fundamentally sound banks (which require less restructuring measures) is justified, will be considered in this paper.

This paper is structured as follows: Subsequent to the introductory section and under the second section, prominence is given to highlighting the distinction between fundamentally sound financial institutions and those not considered to be fundamentally sound. In this respect, the preferential grant of recapitalisation schemes to fundamentally sound financial institutions will be emphasised. The third section will then consider measures which have been established as means of minimising and avoiding distortions of competition. The third section will also consider the extent to which the objective of promoting financial stability should override that of the need to minimise distortions of competition. This section is structured into four parts:

I. Safeguards Against Possible Distortions of Competition in Recapitalisation Schemes
II. Prevention and Limitation of Undue Distortions of Competition.
III. Exit Strategies to Address Distortions to Competition Instituted by Crisis Responses
IV. Recapitalisation Schemes in Respect of Non Fundamentally Sound Institutions and the Grant of State Capital: The Objective of Fostering Competition Overriding the Need to Promote Financial Stability?

The fourth section will then consider the reasons behind the increasing prominence of the role assumed by central banks in regulation – in their capacities as regulator, monetary policy setters and lender of last resort providers. Such a consideration will be facilitated through an overview of the impact of the recent Financial Crisis.

Should lender of last resort arrangements be granted to a wider extent under complementary arrangements which support recapitalisation schemes than those which support guarantee schemes or vice versa? What are the benefits of expanding the role of central banks as opposed to the disadvantages of increased central bank intervention in rescues? These are amongst several points to be deliberated on in this section before a conclusion is drawn in the fifth and final section of the paper.

According to Aaken and Kurtz, the most frequently taken emergency measures with „specific relevance to state commitments under international economic law", can be classified into three extensive categories namely, i)measures designed to bolster the stability of the financial services industry; ii) measures directed at the financial services industry but structured to increase the availability of credit to other sectors of the economy; and (iii) measures targeting select and strategic industries.[9]

## B. State Aids and Recapitalisation Schemes

Article 107 (1) TFEU [ex Article 87(1) EC][10] considers "state aid" to be any aid granted by a Member State or (ii) through state resources in any form whatsoever and which (iii) distorts or threatens to distort competition by favouring certain undertakings as far as it affects trade between Member States.[11]

The Commission's resort to the "rarely used and more lenient provision of Article 87(3)(b) EC Treaty, during the recent Financial Crisis, to authorise national recovery plans and individual rescue measures"[12] is an explicit illustration of its commitment to goals aimed at facilitating economic stability through the aversion of " a serious disturbance in the economy of Member States."[13] Its realisation of the need to implement this provision occurred after Lehman Brothers filed for bankruptcy – the first case to be decided under Article 87(3)(b) EC Treaty being Bradford and Bingley.

In respect of Northern Rock, and with respect to the legal basis of the Commission's decisions, "the rescue decision and the decision of 2 April 2008 to open the formal investigation procedure, were taken on the basis of Article 87(3)(c) of the Treaty and the Rescue and Restructuring Guidelines - the reason for this being that the Commission considered the difficulties faced by Northern Rock to be linked specifically to Northern Rock – therefore not justifying the application of Article 87(3)(b) of the Treaty.

As the severity of the Financial Crisis affected more and more banks, in September 2008, the Commission considered the application of Article 87(3)(b) EC Treaty, to banks that were in receipt of State aid, to be necessary thereafter. As a result, the decision extending the formal investigation procedure and ii) the final decision, were taken on the basis of Article 87 (3)(b) EC Treaty.[14]

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[9] A van Aaken and J Kurtz, „Prudence or Discrimination? Emergency Measures, The Global Financial Crisis and International Economic Law" Journal of International Economic Law 12(4) at page 862.

Aaken and Kurtz also elaborate on „how certain aspects of international economic law might act as a credible constraint on state tendencies toward domestic preference when formalizing emergency responses to the crisis." see also ibid at page 859.

[10] Which establishes that „ (save as otherwise provided in the Treaties), any aid granted by a Member State or through State resources in any form (whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods) shall, in so far as it affects trade between Member States, be incompatible with the Internal Market."

[11] For further information on the definition of State aid see Rodriguez – Miguez J and Ojo M, "Juridical and Financial Considerations on the Public Re Capitalisation and Rescue of Financial Institutions During Periods of Financial Crisis", particularly, pages 12 –15 of 74.

[12] See D Gerard, „Managing the Financial Crisis in Europe: Why Competition Law is Part of the Solution, Not of the Problem" Global Competition Review December 2008 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330326> at page 6

[13] See also M Ojo, "Social rights and economic objectives: The importance of competition at supra national level" <http://mpra.ub.uni-muenchen.de/24265/>

[14] See Z Didziokaite and M Gort, „Restructuring in the Banking Sector During the Financial Crisis: The Northern Rock Case" at pages 3 and 4 of 6 ; also see ibid.

Guarantee schemes could be distinguished from recapitalisation schemes in that recapitalisation schemes are generally used in collaboration with financial institutions that are "fundamentally sound but which may experience distress because of extreme conditions in financial markets."[15] However, the Recapitalisation Communication also makes provision for banks which are not so fundamentally sound.[16]

The objective being the provision of public funds in order "to consolidate the capital base of the financial institutions directly or to facilitate the injection of private capital by other means, so as to prevent negative systemic spill overs."[17]

Under section 2 paragraph 14 of the Banking Communication, distortions of competition resulting from schemes supporting the viability of institutions which are illiquid but otherwise fundamentally sound, will normally be more limited and require less substantial restructuring than those financial institutions which are particularly affected by losses stemming for instance from inefficiencies, poor asset-liability management or risky strategies. In the paper preceding this,[18] the justification for the grant of State aid to institutions whose losses result from inefficiencies, poor asset-liability management or risky strategies was considered. Furthermore, the grant of State aid to such institutions was justified on the basis that systemic relevant institutions within this category[19], whose failure pose such disastrous consequences for financial stability, should not be allowed to fail.

With respect to purposes which the recapitalisation of banks could serve, three common objectives are listed in the Commission's Communication [20] and these are as follows:

- Contribution to the restoration of financial stability as well as the restoration of the confidence needed for the recovery of inter-bank lending. Further, additional capital serves as a cushion during periods of recession by absorbing losses and reducing the likelihood and risk of banks becoming insolvent.[21]

- Facilitating lending to the real economy[22]

[15] Recapitalisation schemes constitute a "second systemic measure in response to the recent financial crisis to be used to support financial institutions that are fundamentally sound but which may experience distress because of extreme conditions in financial markets." See Banking Communication Section 4 paragraph 34 of the "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/C 270/02) at page 5

[16]See Section 2.3 paragraph 43 of the Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition - which states that the recapitalisation of banks which are not fundamentally sound should be subject to stricter requirements. Furthermore, paragraph 44 states that

> "As far as remuneration is concerned, it should in principle reflect the risk profile of the beneficiary and be higher than for fundamentally sound banks. This is without prejudice to the possibility for supervisory authorities to take urgent action where necessary in cases of restructuring."

[17] See section 4 paragraph 34 of the Banking Communication

[18]M Ojo, "Liquidity Assistance and the Provision of State Aid to Financial Institutions" (2010) Munich RePEc and SSRN Working Papers

[19] Category of institutions whose losses result from inefficiencies, poor asset-liability management or risky strategies.

[20] See paragraph 4 of the Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition

[21] ibid

[22] "Fundamentally sound banks may prefer to restrict lending in order to avoid risk and maintain higher capital ratios. State capital injection may prevent credit supply restrictions and limit the pass-on of the financial markets' difficulties to other businesses." see ibid at paragraph 5. Further, according to paragraph 39 of the Recapitalsation Communication, "When Member States use recapitalisation with the objective of financing the real economy, they have to ensure that the aid effectively contributes to this. To that end, in accordance with national regulation, they should attach effective and enforceable national safeguards to recapitalisation which ensure that the injected capital is used to sustain lending to the real economy."

- State recapitalisation could also serve to address and rectify insolvency problems faced by financial institutions – such problems having arisen as a result of such institutions' particular business model or investment strategy.[23]

In respect of this third objective (for which the recapitalisation of banks could serve), it is interesting to note that Paragraph 6 of the Recapitalisation Communication, provides for "problems of financial institutions facing insolvency as a result of their particular business model or investment strategy" - given the fact that paragraphs 4 and 5 explicitly provide for fundamentally sound financial institutions. Whilst paragraph 4 *interalia* states that „additional capital provides a cushion in recessionary times to absorb losses and limits the risk of banks becoming insolvent", paragraph 5 recognises that fundamentally sound banks may prefer to restrict lending in order to avoid risk and maintain higher capital ratios.

According to paragraph 6 of the Recapitalisation Communication, „a capital injection from public sources providing emergency support to an individual bank may also help to avoid short term systemic effects of its possible insolvency. In the longer term, recapitalisation could support efforts to prepare the return of the bank in question to long term viability or its orderly winding-up." Against the back drop of this exceptional provision, a case relating to the grant of capital injections for a non fundamentally sound financial institution will be considered.

Hypo Real Estate (HRE) – Capital Injections

„In April 2010, the German Financial Markets Stabilisation Fund (SoFFin) approved the next recapitalisation tranches of up to €1.85 billion for Hypo Real Estate Holding AG (HRE), within the framework of the existing capital plan. It is planned that this capital be paid into HRE's capital reserve in at least two tranches as necessary. In particular, the recapitalisation is necessary in order for DEPFA BANK plc to maintain its minimum regulatory capital ratios in the near future. The capital measure is subject to approval by the European Commission. Including the support measure at hand, SoFFin has to date, provided total recapitalisation support of around € 7.85 billion to the HRE Group."[24]

Having regards to i) Article 87(3)(b) EC Treaty which enables the Commission to declare aid compatible with the Common Market if it is "to remedy a serious disturbance in the economy of a Member State"; the fact that ii) Germany considered HRE to be a bank with systemic relevance for the financial market, iii) BaFin confirmed that the own capital of the bank would fall short of the regulatory requirements if the bank did not receive further capital and iv) that bank supervisory procedures would be initiated if the bank did not receive further capital, the Commission assessed the State aid measures for HRE under Article 87(3)(b) of the EC Treaty.[25]

[23] Furthermore recapitalisation may also respectively serve to address short term and long term systemic effects through capital injections from public sources providing emergency support to an individual bank and "supporting efforts to prepare the return of the bank in question to long term viability or its orderly winding-up." see ibid at paragraph 6

[24]See „SoFFin passes resolution on € 1.85 billion recapitalisation for HRE" 30 April 2010 <http://www.hyporealestate.com/eng/pdf/1004recaptranch_e.pdf> „In 2007, HRE took over the Dublin-based DEPFA Bank plc and extended its business to public sector and infrastructure finance. HRE currently consists of the following main companies: Hypo Real Estate Holding AG, Deutsche Pfandbriefbank AG and DEPFA Bank plc." see European Commission, „State Aids n° C 15/2009 (ex N 196/2009), N 333/2009 & N 557/2009 – Germany Hypo Real Estate – Extension of Formal Investigation Procedure, and Temporary Find Capital Injections Compatible" at paragraphs 12 and 13

[25]See European Commission, „State Aids n° C 15/2009 (ex N 196/2009), N 333/2009 & N 557/2009 – Germany Hypo Real Estate – Extension of Formal Investigation Procedure, and Temporary Find Capital Injections Compatible" paragraphs 41 and 42, at pages 6 and 7; „The Commission re iterated is doubts on the viability of HRE in its decision (Decision C(2009) 5888 final) of 24 July 2009 and the present case, taking into account the more detailed figures in the

„The Commission decided to assess the temporary compatibility of capital measures until a decision on the restructuring plan was taken - since Germany had asked for temporary approval of the capital measures. If the measures were held to be compatible the Commission decided it would not consider whether the measures were already compatible under the German rescue aid scheme.“[26]

Even though HRE was in the process of restructuring at the time, and Germany had already provided a restructuring plan which was subsequently updated and was being assessed by the Commission at the time, the need to temporarily grant emergency aid prior to the final assessment of the revised restructuring plan was acknowledged since financial stability was at stake in the prevailing case and urgent remedial action was required to keep the ailing bank afloat – this also being confirmed by the national financial supervisory authority.[27]

In its decision, the Commission decided to temporarily find compatible with the Common Market the capital injection amounting to EUR 60 million carried out in March 2009[28], the capital injection amounting to EUR 2 959 632 240 carried out in June 2009, and the capital injection amounting to EUR 3.0 billion to be carried out in November 2009 in favour of HRE until the Commission has taken a final decision on the restructuring plan.[29] Furthermore the Commission concluded that the capital injections „are appropriate, necessary and proportional, and can be considered compatible with the Common Market on a temporary basis until a final decision was taken on the restructuring plan of HRE.“[30]

Such a decision to accord priority to financial stability will be contrasted to other scenarios which give more preference to the need to minimise and avoid distortions of competition in the next section.

updated restructuring plan and questioning whether the intended restructuring was sufficient to allow restoration of long-term viability on the basis of the State aid received and planned.

The Commission also identified three problematic aspects that could affect the long-term sustainability of HRE's business model – which it intended to investigate further. The three problematic aspects included:i) Funding, ii)Short- and long-term profitability and (iii)the fact that HREindicated in its revised business plan that it wanted to remain active in two fields: Commercial Real Estate and Public Finance. Nevertheless, the Commission observed at the time that the intended margin in the area of public finance was very low and that market pressure could further reduce achievable margins.“ See paragraphs 58 -61;ibid

[26]See ibid at paragraph 44

[27]Ibid at paragraph 48

[28]„With regard to its silent participation of EUR 1 billion, SoFFin was to receive a profit-related coupon of 10 %. This level of remuneration was considered to be in line with paragraph 44 of the Recapitalisation Communication, which stipulates that where the price cannot be set to levels that correspond to the risk profile of the bank, it would nevertheless need to be close to that required for a similar bank under normal market conditions. Moreover, the Commission highlighted the fact that HRE would not get capital at an economically justifiable remuneration level on the market in the current circumstances but that given the fact that HRE was in difficulty, it should pay at least a reasonable price - that 10 % was considered to be an acceptable level.“ (See Commission decision of 12 May 2009 in case N 615/2008, *BayernLB);* see paragraph 52; ibid.

[29]See ibid;section 5 at page 11; „The capital injection of EUR 60 million had only limited scope, resulting in a 8.65% share of HRE's equity capital which did not give Germany a major influence on the bank“; see paragraph 49

[30]Ibid at paragraph 54

## C. Minimising and Avoiding Distortions of Competition

### I. Safeguards Against Possible Distortions of Competition in Recapitalisation Schemes.[31]

As well as highlighting the Banking Communication's emphasis on the need for safeguards aimed at preventing and limiting possible distortions of competition in recapitalisation schemes,[32] paragraph 35 of the Recapitalisation Communication also makes mention of the Banking Communication's requirement[33] that capital injections be limited to the minimum necessary and not to allow the beneficiary to engage in aggressive commercial strategies which would be incompatible with the underlying objectives of recapitalisation. Where higher remuneration is required by the State, there will (as a general principle) be less need for safeguards - since the level of price, in the Commission's view, will limit distortions of competition.[34]

However this can be contrasted with the case involving Hypo Real Estate where in respect of the capital injections carried out by acquiring share capital and the injection into the reserves, the German authorities highlighted that SoFFin as 100% HRE owner, was entitled to a shareholder's usual remuneration. Furthermore, it was stated that „for a distressed bank, no market-conform remuneration can be expected, at least in the short-term, for such provision of capital and that in line with the Recapitalisation Communication, such a situation required a thorough and far-reaching restructuring."[35]

Safeguards which have been proposed as means of preventing distortions of competition with guarantee schemes include restrictions on commercial conducts through for example market share ceilings, limitations to the size of the balance-sheet of the beneficiary institutions or other behavioural constraints that may be needed to achieve the purpose of the guarantee.[36] Issues which are also considered to arise with these safeguards include:[37]

1) How they can be properly monitored and enforced since financial services are typically not regarded as standardized products.

2) The likelihood that some restrictions such as those on the growth of undertaking may themselves generate anticompetitive effects in terms of collusive agreements.

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[31] In the Commission's view, „Safeguards may be necessary to prevent aggressive commercial expansion financed by State aid. In principle, mergers and acquisitions can constitute a valuable contribution to the consolidation of the banking industry with a view to achieving the objectives of stabilising financial markets and ensuring a steady flow of credit to the real economy. In order not to privilege those institutions with public support to the detriment of competitors without such support, mergers and acquisitions should generally be organised on the basis of a competitive tendering process." see paragraph 37 of the Recapitalisation Communication.

[32] Paragraph 35 of the Banking Communication

[33] Paragraph 38 of the Banking Communication

[34] „Banks receiving State recapitalisation should also avoid advertising it for commercial purposes." See paragraph 36 of the Recapitalisation Communication. (Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition )

[35] See paragraph 53 of European Commission, „State Aids n° C 15/2009 (ex N 196/2009), N 333/2009 & N 557/2009 – Germany Hypo Real Estate – Extension of Formal Investigation Procedure, and Temporary Find Capital Injections Compatible"

[36] Organisation for Economic Cooperation and Development, "Competition and the Financial Crisis" Organisation for Economic Cooperation and Development Publications February 2009 at page 15.*Paper served as the basis for a discussion on the financial crisis in the OECD Competition Committee on 17-18 February 2009 and is published under the responsibility of the Secretary General of the OECD.* <http://www.oecd.org/dataoecd/52/24/42538399.pdf>

[37] ibid

3) Of paramount importance is the concern related to the remuneration of the guarantee scheme or any other form of intervention such as the recapitalization schemes. [38]

II. Prevention and Limitation of Undue Distortions of Competition

Three levels of possible distortions of competition are highlighted in the Commission Communication[39] on the Recapitalisation of Financial Institutions and these are as follows:[40]

- First, recapitalisation by one Member State of its own banks should not give those banks an undue competitive advantage over banks in other Member States. Access to capital at considerably lower rates than competitors from other Member States, in the absence of an appropriate risk-based justification, may have a substantial impact on the competitive position of a bank in the wider single European market.[41]

- Secondly, recapitalisation schemes which are open to all banks within a Member State without an appropriate degree of differentiation between beneficiary banks according to their risk profiles may give an undue advantage to distressed or less-performing banks compared to banks which are fundamentally sound and better-performing.[42]

- Thirdly, public recapitalisation, in particular its remuneration, should not have the effect of putting banks that do not have recourse to public funding, but seek additional capital on the market, in a significantly less competitive position.[43]

In considering whether State aid (and in particular emergency guarantees) was to be granted to Hypo Real Estate, the Commission in attempting to ensure that distortions of competition were minimised (as far as possible), considered the Requirement that aid granted "does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimized as far as possible" - in line with the general principles which constitute the basis of State aid rules of the Treaty, which require that the aid granted "does not exceed what is strictly

[38]„In principle, the remuneration of any type of support such as the issuance of new shares or asset swaps should be determined on the basis of a market-oriented valuation and be as close as possible to the market rate. However, at the current moment, the pricing mechanism in the markets seems to have stopped working properly. In such a situation, an important question is how to explicitly calculate an appropriate remuneration for the public supports in a time when markets are so highly illiquid and volatile that market prices may no longer be tied to the value of fundamentals. This issue resembles the current de"bate in the application of mark-to-market accounting standards when markets do not work properly." ibid

[39] See paragraphs 7-10 of the Communication from the Commission – „The recapitalisation of Financial Institutions in the Current Financial Crisis: Limitation of aid to the Minimum Necessary and Safeguards Against Undue Distortions of Competition

[40]See paragraphs 8 -10; ibid

[41]„ Excessive aid in one Member State could also prompt a subsidy race among Member States and create difficulties for the economies of Member States which have not introduced recapitalisation schemes. A coherent and coordinated approach to the remuneration of public capital injections, and to the other conditions attached to recapitalisation, is indispensable to the preservation of a level playing field. Unilateral and uncoordinated action in this area may also undermine efforts to restore financial stability ('Ensuring fair competition between Member States')."

[42]„ This will distort competition on the market, distort incentives, increase moral hazard and weaken the overall competitiveness of European banks ('Ensuring fair competition between banks')."

[43]"A public scheme which crowds out market-based operations will frustrate the return to normal market functioning ('Ensuring a return to normal market functioning')."

necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimized as far as possible."[44]

## III. Exit Strategies to Address Distortions to Competition Instituted by Crisis Responses

According to the Recapitalisation Communication, „recapitalisation measures need to contain appropriate incentives for State capital to be redeemed when the market so allows. The simplest way to provide an incentive for banks to look for alternative capital is for Member States to require an adequately high remuneration for the State recapitalisation."[45]

Furthermore, the Communication states that „if a Member State prefers not to increase the nominal rate of remuneration, it may consider increasing the global remuneration through call options or other redemption clauses, or mechanisms that encourage private capital raising, for instance by linking the payment of dividends to an obligatory remuneration of the State which increases over time."[46]

In facilitating exit strategies, „member States may also consider using a restrictive dividend policy to ensure the temporary character of State intervention."[47]

The OECD's proposal is founded on the distinction between the types of aid provided for i) financial firms for systemic reasons and ii) for non-financial firms with structural problems. As pre requisite for the grant of aid to non financial firms, the requirement that " structural reforms to a sustainable industry structure" exist, was put forward.[48]

Furthermore, "the need to ensure that structural reforms promote the long-term viability of these firms" is considered to constitute part of an exit strategy.[49] Other forms of aid considered include:[50]

- nationalization of financial institutions or non-financial firms;
- state-sponsored capital injections[51]
- extended liquidity facilities;
- interbank lending guarantees; and
- state acquisition of so-called "toxic assets".

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[44]European Commission, "European Commission State aid n° N 694/2009 – Germany Emergency guarantees for Hypo Real Estate"

[45]See paragraph 31

[46]See paragraph 32 of the Recapitalisation Communication.

[47]See paragraph 32 of the Recapitalisation Communication

[48]See Organisation for Economic Co operation Development, "Competition and the Financial Crisis" at page 22

[49]ibid

[50]ibid

[51]„In the European Union, relevant competition decisions have included Commission Decision of 13 October 2008 in Case N 507/08 *Financial Support Measures to the banking Industry in the UK* (OJ C 290, 13.11.2008, p. 4), Commission Decision of 27 October 2008 in Case N 512/08 *Support measures for financial institutions in Germany* (OJ C 293, 15.11.2008, p. 2) and Commission Decision of 19 November 2008 in Case N 560/08 *Support measures for the credit institutions in Greece*, Commission Decision of 12 November 2008 in Case N 528/08 the Netherlands, *Aid to ING Groep N.V.*, Commission Decision of 25 November 2008 in Case NN 68/08 on *Latvian State support to JSC Parex Banka*. Commission Communication of 13 October on The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (OJ C 270, 25.10.2008, p.8) and European Commission principles are outlined in Commission Communication of 5 December on The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortion of competition (OJ C 10, 15.1.2009 p.2)." see OECD, "Competition and the Financial Crisis" at page 22

## IV. Recapitalisation Schemes in Respect of Non Fundamentally Sound Institutions and the Grant of State Capital: The Objective of Fostering Competition Overriding the Need to Promote Financial Stability?

Why should financial institutions whose problems are attributable to inefficiencies, poor asset liability management or risky strategies not be accorded the same treatment as those whose viability problems are exogenously induced (and also related to extreme conditions which prevail in the financial market) as far as such "non fundamentally sound" institutions are considered to be systemically relevant?

Section 2.3 paragraphs 43 and 44 of the Recapitalisation Communication highlights safeguards which are available where the grant of State capital to non fundamentally sound institutions are approved. Banks which would require more far reaching restructuring and which are considered not to be fundamentally sound are subject to more stringent requirements than fundamentally sound financial institutions (which would require less restructuring). Such stringent requirements include:

- The requirement that remuneration should "in principle reflect the risk profile of the beneficiary and be higher (for non fundamentally sound banks) than for fundamentally sound banks - without prejudice to the possibility for supervisory authorities to take urgent action where necessary in cases of restructuring."[52]

- The acceptability and approval of use of State capital for non fundamentally sound banks being dependent on the condition of either a bank's winding-up or a thorough and far-reaching restructuring, including a change in management and corporate governance where appropriate. [53]

The Commission in its Communication explicitly states that „Notwithstanding the need to ensure financial stability, the use of State capital for these banks (non fundamentally sound financial institutions) can only be accepted on the condition of either a bank's winding-up or a thorough and far-reaching restructuring, including a change in management and corporate governance where appropriate."[54]

Does this infer that the Commission is prepared to override the paramount objective of financial stability – by according greater prominence to the goal of fostering competition? This might initially appear to be the case. As highlighted in the second section of its predecessor paper[55], financial institutions whose problems are attributed to "inefficiencies, poor asset-liability management or risky strategies" and which are considered to be systemically relevant, should benefit from state aid where restructuring of such institutions occur – to the extent that senior

[52]See paragraph 44 which furthermore adds that "Where the price cannot be set to levels that correspond to the risk profile of the bank, it would nevertheless need to be close to that required for a similar bank under normal market conditions. "

[53]"As a result, either a comprehensive restructuring plan or a liquidation plan will have to be presented for these banks within six months of recapitalisation. As indicated in the Banking Communication, such a plan will be assessed according to the principles of the rescue and and restructuring guidelines for firms in difficulties, and will have to include compensatory measures."

[54]See paragraph 44 of the Recapitalisation Communication. (Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition )

[55]See M Ojo, "Liquidity Assistance and the Provision of State Aid to Financial Institutions" (2010) Munich RePEc and SSRN Working Papers

management (or indeed the entire management) of those institutions are replaced.

Such intentional safeguard by the Commission whilst ensuring that competition is not unduly distorted, also serves as a warning to "too big to fail firms" that guaranteed government or central bank intervention in the case of impending financial difficulties does not serve as an excuse for complacency or reckless risk taking behaviour. Such a move by the Commission is therefore aimed at deterring moral hazard whilst fostering competition.

## D. The Increased Prominence of the Role Assumed by Central Banks – The Impact of the Recent Financial Crisis.

### I. Traditional Roles of Central Banks

1) Lender of Last Resort Arrangements[56]

The need for the creation of bridge banks and a Special Resolution Regime (SRR) was brought to light following numerous related proposals which were put forward following the financial woes of banks such as Northern Rock and Hypo Real Estate.[57]

One of the weaknesses of central banks which was revealed during the Financial Crisis was the inability of the Bank of England to perform its traditional role as lender of last resort for a limited period of time (without such a role being made public) – which created problems that triggered the run on Northern Rock.

Unconventional measures which were introduced by advanced economies in response to the latter stages of 2008 include liquidity provision to banks on extra ordinary terms – particularly for longer periods of maturity and intervention in selected credit markets.[58]

2)Oversight of payment systems

Furthermore, as observed by Hannoun[59], central banks are increasingly being put in charge of overseeing systemic risk. Such an innovative role can be considered to be an extension of their traditional role as overseers of payment systems. Hannoun goes on to attribute the delegation of such responsibility for the oversight of systemic risk as owing to their unique positions as ultimate providers of liquidity – which places them in a such a formidable stance to focus on system wide risks (as well as obtaining an integrated view of both the individual financial institutions and the financial system as a whole).[60]

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[56] For more information on the role of the lender of last resort, see RM Lastra, and A Campbell, 'Revisiting the Lender of Last Resort. The Role of the Bank of England', book chapter (Ch. 10) in *The Future of Financial Regulation,* edited by Iain G MacNeil and Justin O'Brien, Hart Publishing 2010, pp. 161-178.

[57] For further information on bridge banks and means whereby ailing banks could efficiently be relieved of their assets, see D Schäfer and KF Zimmerman, "Bad Bank (s) and Re capitalization of the Banking Sector" (2009) Discussion Paper 897 of DIW Berlin <http://www.voxeu.org/index.php?q=node/3656>

[58] "Such a measure being aimed at supporting secondary market liquidity and the outright purchase of bonds". See H Hannoun, "The Expanding Role of Central Banks Since the Crisis: What are the Limits?" June 2010 Bank for International Settlements Publications http://www.bis.org/speeches/sp100622.pdf?noframes=1 at page 3

[59] see ibid

[60] ibid

In addition to their unique position as ultimate providers of liquidity, the extensive knowledge possessed by central banks – such knowledge and expertise being attributed to their role as overseers of payment systems, their means of acquiring such knowledge and expertise, places them in a formidable position in matters relating to the responsibility for macro prudential supervision.

Two examples have been put forward to bolster the argument that "the macro prudential approach to supervision should take into consideration the fact that, even when financial institutions appear to be strong on an individual basis, systemic risk could still emerge as a result of the interconnectedness of financial institutions, markets and infrastructures" - such examples being the creation of the European Systemic Risk Board (ESRB) and the proposed Financial Stability Oversight Council in the United States.[61]

The Role of Central Banks in Managing Liquidity[62] Risks

As well as highlighting the need to address the question on how much maturity transformation is needed – in matters relating to maturity transformation and liquidity risks, it is argued that "maturity transformation is one of those areas which we rely on the banking system to perform and that since there may never be enough short-term liabilities issued by governments and the private sector (to satisfy the demand for liquid short-term savings instruments), that the primary function of banks in providing these vehicles to the public, should be welcomed."[63]

The likelihood that banks are exposed to significant levels of liquidity risks arises from the nature of commercial banks' business, namely, the fact that such business involves, to a fundamental extent, maturity transformation.

The provision of central bank reserves account serves as a means whereby commercial banks are able to manage their liquidity risk – through a process which enables them to meet their "ordinary payment needs – including normal intra day variations."[64]

Over the recent years, it has increasingly been acknowledged that macro prudential policies are not only considered to be "a missing ingredient from the current policy framework", but that there has also been "too huge a gap between macro economic policy and the regulation of individual financial institutions."[65]

According to recent observations, some aspects of the more prominent role which central banks have assumed since the recent Crisis (such a role being partly attributed to circumstances triggered

[61] ibid

[62] "Liquidity is the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses." See Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision" < http://www.bis.org/publ/bcbs144.pdf>

[63] See S Cecchetti, „Financial Reform: A Progress Report" Remarks prepared for the Westminster Economic Forum, National Institute of Economic and Social Research, October 2010 at page 4 of 6 http://www.bis.org/speeches/sp101004.htm

[64] Maturity transformation is evident within the banking system and day to day business operations since "customer deposits may be available for instant withdrawals while bank lending to corporations and households tends to be committed, potentially for many years." See P Fisher, „Managing Liquidity in the System – the Bank's Liquidity Insurance Operations" at page 2 <http://www.bis.org/review/r101004e.pdf>

[65] Please also refer to abstract; See Bank of England, Executive Summary "Role of Macro Prudential Policy" Discussion Paper November 2009 at page 3 http://www.bankofengland.co.uk/publications/other/financialstability/roleofmacroprudentialpolicy091121.pdf

by the recent financial Crisis), are likely to become more permanent during the aftermath of the Crisis.[66] Unconventional measures which were introduced by advanced economies in response to the latter stages of 2008 include liquidity provision to banks on extra ordinary terms – particularly for longer periods of maturity, intervention in selected credit markets – a measure aimed at supporting secondary market liquidity and the outright purchase of bonds – such purchase being aimed at improving financing conditions beyond that which can be achieved by policy rate cuts.[67]

Tools implemented by the Federal Reserve Board, in its response to the recent Crisis, have been classified into three:[68]

- The first set of tools, which are closely tied to the central bank's traditional role as the lender of last resort, which involve the provision of short-term liquidity to banks and other depository institutions and other financial institutions.[69]
- A second set of tools, which involve the provision of liquidity directly to borrowers and investors in key credit markets.[70]
- A third set of instruments, through which the Federal Reserve has expanded its traditional tool of open market operations to support the functioning of credit markets through the purchase of longer-term securities for the Federal Reserve's portfolio."

In addition to the reduction of the federal funds rate, Kohn provides a list of actions which have been taken by the Federal Reserve to ease conditions in credit markets more directly (referred to as "credit easing").[71] He regards such actions as „extensions of traditional methods of operation which have resulted in a new territory in which tools have been implemented in very new ways."[72]

He elaborates further on the measures which have been taken by the Fed Reserve through a flashback to the start of the Financial Crisis when:[73]

- The terms on which lending was provided to depository institutions (traditional borrowers) were eased quite dramatically. This was followed by the lowering of interest rate on discount window loans, an increase in their maturity, and, auctioned credit (aimed at reducing the stigma of borrowing from the window). Cooperative measures with foreign central banks through currency swaps (to make dollar funding available to banks operating abroad) also took place.

He then recounts how, for the first time since the 1930s, credit was extended to non depository institutions – as well as the grant of discount window access to primary dealers when it became evident that constraints on their access to liquidity threatened broader financial stability and economic activity.[74]

[66] H Hannoun "The Expanding Role of Central banks Since the crisis: What are the Limits?" June 2010 Bank for International Settlements Publications http://www.bis.org/speeches/sp100622.pdf?noframes=1 at page 1

[67] ibid at page 3

[68] See Federal Reserve Board „The Federal Reserve Board's Response to the Crisis" <http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm>

[69] „The traditional discount window, Term Auction Facility, PDCF, and TSLF are classified into this category." ibid

[70] „The CPFF, AMLF, MMIFF, and the Term Asset-Backed Securities Loan Facility (TALF) are classified into this category. „;ibid

[71] D Kohn, „Monetary Policy in the Financial Crisis" Federal Reserve Board Publications April 2009 <http://www.federalreserve.gov/newsevents/speech/kohn20090418a.htm>

[72] Please refer to abstract

[73] See D Kohn, „Monetary Policy in the Financial Crisis" Federal Reserve Board Publications April 2009 <http://www.federalreserve.gov/newsevents/speech/kohn20090418a.htm>

[74] He also provides an illustration in relation to last Autumn when „a run on money market mutual funds was severely constricting their purchases of commercial paper, an important source of credit to many businesses." In this respect he

II. Macro Prudential Supervision and Basel III

Under its macro prudential overlay and its efforts to address stability over time (pro cyclicality), one of those initiatives highlighted under the Basel III framework includes counter cyclical capital charges and forward looking provisioning.

Progress made with Counter Cyclical Measures in Various Jurisdictions

According to Brunnermeier et al, counter cyclical measures should be applied on a country specific basis since cycles are not identical across several jurisdictions around the world.[75] In their opinion, it is yet too early to talk about a "global cycle" since "credit expansion has taken place at a very different pace in various countries."[76] As observed by Caprio Jr, even though[77] no country thus far had adopted a counter cyclical capital requirement policy, as recommended by Brunnermeier et al, a few have adopted counter cyclical provisioning – Spain being the first to implement such, followed by Colombia and much more recently, Peru.[78]

Measures aimed at "building up reserves over the cycle which might be part of regulatory capital or separate from it and which would amount to 2 – 3 % of risk weighted assets at the peak of a boom" have been proposed in the UK by its financial services regulator, the Financial Services Authority.[79] Other measures of counter cyclical regulation which are being considered by other jurisdictions (and which would "limit the scope under Basel 2 arrangements for banks to assess their own risk by providing a one-size fits all ceiling and may be beneficial in making regulation more transparent)[80] could include "an overall leverage ratio of capital to unadjusted assets (rather than risk weighted assets)."[81]

Dynamic Provisioning

Whilst the principles of the Spanish Dynamic Provision Mechanism are lauded by Brunnermeier et al, its "quantitative effect" is not considered by them to have had a moderate effect on the credit cycle – to the same extent as their proposed mechanism. Its universal adoption[82], is however, considered to represent a " counter- cyclical- lite" in the case where their proposal (Brunnermeier et

adds that „the funds, their customers, and their borrowers were supported by making credit available – credit which allowed funds to meet heavy redemption requests and which also provided credit directly to borrowers in the commercial paper market."

[75] See M Brunnermeier et al, "The Fundamental Principles of Financial Regulation" Geneva Reports on the World Economy, 11< http://www.princeton.edu/~markus/research/papers/Geneva11.pdf> at page 37 (page 55 of 98)
[76] In this respect, they illustrate with the example that Germany and Italy did not share in the housing cycle that affected the USA, UK, Spain etc. See ibid
[77] As of February 2010
[78] See G Caprio Jr, "Safe and Sound Banking: A Role for Counter cyclical Regulatory Requirements" World Bank Policy Research Working Paper 5198, The World Bank Development Research Group, Finance and Private Sector Development Team, February 2010 at page 11
[79] See E P Davis and D Karim, "Macro Prudential Regulation – The Missing Policy Pillar" Keynote Address at the 6th Euro frame Conference on Economic Policy Issues in the European Union, 12th June 2009, entitled „Causes and Consequences of the Current Financial Crisis, What lessons for EU Countries?" at page 10 and also Financial Services Authority, "The Turner Review: A Regulatory Response to the Global banking Crisis" FSA Publications 2009
[80] Although it is added that "it is essential that such ceiling applies to all relevant assets and does not encourage banks to use off-balance structures to evade such a ceiling" See E P Davis and D Karim, "Macro Prudential Regulation – The Missing Policy Pillar" Keynote Address at the 6th Euro frame Conference on Economic Policy Issues in the European Union, 12th June 2009, entitled „Causes and Consequences of the Current Financial Crisis, What lessons for EU Countries?" at page 10
[81] ibid
[82] „Including the adjustment of IFRS to allow that to occur"

al’s proposal) is considered as being too radical.

## III. Why Central Banks Assume Such a Crucial Role Given the Present Framework of Basel III

In its present form, Basel III accords much pre eminence to the need for macro prudential supervision – as well as a macro prudential framework.

Central banks, it is argued, have a key role to play in establishing such a macro prudential framework – as well as a role in macro prudential supervision and regulation for the following reasons:[83]

Developing and structuring macro prudential measures requires reliable analytical and forecasting skills – for instance, with regard to the overall economy or specific market segments. Central banks have extensive and soundly based knowledge of these fields.

Macro prudential policy interacts closely with monetary policy – which implies that information advantage of central banks could be important in shaping macro prudential measures

We may then infer that central banks' crucial roles in establishing a macro prudential framework provide the key to bridging the gap between macro economic policy and the regulation of individual financial institutions. This however, on its own, is insufficient – close collaboration and effective information sharing between central banks and regulatory authorities is paramount. Principle 17 of the Principles for Sound Liquidity Risk Management and Supervision[84] consolidates on this argument.

Principle 17 of the Principles for Sound Liquidity Risk Management and Supervision[85] elaborates on how cooperation and information sharing between relevant public authorities (including bank supervisors, central banks and securities regulators) can contribute significantly to the effectiveness of the roles assumed by these authorities.

Such communication will not only facilitate a process where:[86]

Supervisors are able to improve their assessments of the overall profile of a bank and the risks it faces (and help other authorities assess the risks presented to the broader financial system); but also

Assist supervisors in informing central banks of their judgement regarding the range of liquidity risks faced by firms (for which they are responsible) while central banks may help supervisors deepen their understanding of the current financial market environment and risks to the financial system as a whole

Central banks’ knowledge of information on market conditions could also be beneficial for supervisors in their assessment of the “appropriateness of assumptions made by banks in stress test scenarios and contingency funding plans.”[87] Furthermore, in their role as overseers of the payment

[83] TJ Jordan, „A Changing Role for Central Banks ?“ Speech by Mr Thomas J Jordan, Vice Chairman of the Governing Board of the Swiss National Bank, at the Welcome Event Master of Banking and Finance, St. Gallen, 22 September 2010, page 4

http://www.bis.org/review/r100924b.pdf

[84] See Basel Committee on Banking Supervision, “Principles for Sound Liquidity Risk Management and Supervision” paragraph 144, at page 34 < http://www.bis.org/publ/bcbs144.pdf>

[85] ibid

[86] see ibid at page 35

[87] ibid

and settlement system, central banks are able to assist supervisors in "deepening their understanding of the linkages between institutions and the potential for disruptions to spread across the financial system."[88]

In addition to the general practice undertaken by central banks - which involves the implementation of frequent "Financial Stability Reviews" which are aimed at evaluating the outlook for financial stability, "the initial policy objectives" of macro prudential regulation, according to Davis and Karim include the early identification of potential vulnerabilities and the encouragement of such financial institutions to undertake stress testing (this being facilitated through the public reporting which is carried out by financial institutions).[89]

## IV. Re delineating Duties and Roles of Central Banks and Supervisory Agencies in Matters relating to Regulation and Supervision

As was highlighted in a previous paper,[90] even though the aftermath of the recent Financial Crises is likely to witness the era of more prominent roles being transferred to central banks across several jurisdictions, a fundamental change and re-definition in roles and responsibilities between national supervisors and central banks is expected in the United Kingdom – as compared to jurisdictions such as Germany and the United States.[91]

The Banking Reform Act in the UK, not only provides the Bank of England with " a legal objective to contribute to protecting and enhancing the stability of the financial systems of the UK but also formalises the Bank of England's role in the supervision of payment systems."[92] The ability of the Bank to request data from banks through the regulator, the FSA, as compared to the present situation where the FSA is only able to collect data it requires itself, is considered to be "an important innovation"[93] under the Act. These arrangements under the Act are also considered to be an important and vital means whereby the Bank is able to acquire "more detailed understanding of developments about the banking system."[94]

„On 19 November 2009 the Chancellor of the Exchequer introduced the Financial Services Bill into Parliament. The Bill, which reforms financial services regulation and contains provisions to improve redress for consumers, and financial education and awareness, received Royal Assent on 8 April 2010. The Act includes:[95]

- A new statutory financial stability objective for the Financial Services Authority (FSA);

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[88] ibid

[89] See E P Davis and D Karim, "Macro Prudential Regulation – The Missing Policy Pillar" Keynote address at the 6th Euro frame Conference on Economic Policy Issues in the European Union, 12th June 2009, entitled "Causes and Consequences of the Current Financial Crisis, What Lessons for EU Countries?" see particularly pages 10 and 11 http://www.euroframe.org/fileadmin/user_upload/euroframe/docs/2009/EUROF09_macroprudential_regulation.pdf

[90] See J Rodriguez - Miguez and M Ojo, "Juridical and Financial Considerations on the Public Re Capitalisation and Rescue of Financial Institutions During Periods of Financial Crisis" <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1646320>

[91] ibid

[92] E P Davis and D Karim, "Macro Prudential Regulation – The Missing Policy Pillar" Keynote address at the 6th Euro frame Conference on Economic Policy Issues in the European Union, 12th June 2009, entitled "Causes and Consequences of the Current Financial Crisis, What Lessons for EU Countries?" at page 12 http://www.qass.org.uk/2009-July_Brunel-conference/Davis.pdf

[93] See ibid

[94] ibid

[95] HM Treasury, „Financial Services Act" http://www.hm-treasury.gov.uk/fin_bill_index.htm

- A new independent consumer financial education body, established by the FSA;
- Provision for regulations on remuneration transparency, and a duty for the FSA to make rules on remuneration;
- A duty for the FSA to make rules requiring firms to produce recovery and resolution plans (also known as "living wills");
- Power for the FSA to ban short selling of certain instruments, and establish a permanent disclosure regime; and

Greater disciplinary powers for the FSA, including earlier disclosure of investigations."

The new statutory duty conferred on the UK's financial services regulator (the FSA), namely, the new financial stability objective, is aimed at reinforcing the FSA's international focus.[96] Such an aim required not only "a consideration of the importance of re affirming the roles of the Treasury, Bank of England and the FSA, but also the need to establish mechanisms which would help ensure that the tripartite authorities speak with a common voice in international fora."[97] Of paramount importance is the expectation that such a statutory duty would complement the Government and the Bank of England's responsibility.[98]

Hence whilst, greater powers have been transferred to the Bank of England[99], the FSA has also acquired a new statutory duty – in addition to the previous four statutory objectives.

Whilst the need for a greater role for central banks in facilitating financial stability and promoting systemic oversight is a positive and justified development, the growing intervention of central banks in financial markets gives rise to concerns. The recent Financial Crisis witnessed a series of rescues and restructuring of financial institutions – such being facilitated by State aids – hence government intervention. Central bank intervention provides an invaluable source of liquidity funding in terms timeliness (particularly in view of urgent scenarios) when compared to State aids. The promptness of central banks in addressing serious liquidity problems faced by financial institutions has contributed to the realisation that its role in promoting financial stability should be accorded greater prominence. At the same time, it appears to be widely acknowledged that "the role of the lender of last resort facility should not be used to address individual bank insolvencies."[100]

The "classic" view – under which it is held that "central banks should lend freely at a penalty rate as well as against good collateral"[101] is considered to serve as a means of ensuring that :[102]

- 1) The lender of last resort is only used for illiquid banks
- 2) In emergency situations

[96] See HM Treasury, *Reforming Financial Markets* July 2009 at page 99
[97] „"Whilst continuing to give adequate attention to regulatory debates" ibid
[98] ibid
[99] As well as responsibility for systemic oversight, the grant of further supplementary oversight functions to the Bank of England, it is further argued, will be desirable. For further information on this, see Shearman and Sterling LLP, "UK Government Proposals for Financial Regulatory Reform" June 2010 and Treasury Select Committee, "Banking Crisis: Regulation and Supervision_ Macro prudential Supervision" http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/767/76707.htm
[100] See Organisation for Economic Cooperation and Development, "Competition and the Financial Crisis" at page 6 of 28
[101] „Another reason why central banks need to unwind their intervention in financial markets is that they are not immune to credit risk. The conventional rule is that central bank lending must be fully collateralised. Unsecured lending is a risky art, requiring discretion, which is incompatible with the principles of transparency and equal treatment in access to central bank credit. Nor is it consistent with the accountability of the central bank." See H Hannoun "The Expanding Role of Central banks Since the crisis: What are the Limits?" June 2010 Bank for International Settlements Publications http://www.bis.org/speeches/sp100622.pdf?noframes=1 at page 9
[102] See Organisation for Economic Cooperation and Development, "Competition and the Financial Crisis" at page 6 of 28

A restricted application of the lender of last resort facility (as much as possible) is not only justified on the basis that moral hazard could occur – since banks or financial institutions experiencing financial difficulty will almost always expect to be bailed out when such a need arises (and hence will be induced to take greater levels of risks than the case would have been if no such facility had existed). It is also argued that "the sustained bloating of their balance sheets means that central banks still dominate some financial market segments thereby distorting the pricing of some important bonds and loans, discouraging necessary market-making by private individuals and institutions."[103]

V. Should lender of last resort arrangements be granted to a wider extent under complementary arrangements which support recapitalisation schemes than those which support guarantee schemes or vice versa?

Lender of last resort arrangements should be granted to illiquid systemically relevant financial institutions in emergency situations. This is partly attributed to the fact that Paragraph 6 of the Recapitalisation Communication, interestingly, provides for "problems of financial institutions facing insolvency as a result of their particular business model or investment strategy."

Other reasons why the lender of last resort facility should be used for emergency situations and systemically relevant institutions in particular, are attributed to the role played by central banks during the recent crisis – during which the role of central banks "in stepping in to replace disrupted and dislocated funding markets"[104] was highlighted. In drawing attention to such developments, the need to avoid dependency on the central bank – to the extent that it does not become the "lender of first resort" (whenever the markets reveal signs of impeding financial failures), is also emphasised.[105]

Given the scale of government intervention and State rescues which occurred during the recent crisis –as well as the prominence accorded to measures aimed at preventing and limiting distortions of competition, calls have been made for competition authorities to take on more formidable roles in designing and implementing exit strategies. In order to foster competition as much as possible, it is proposed that "governments should provide financial institutions with incentives to prevent them from depending on government support once the economy begins to recover."[106] Such incentives, it is further argued, could assume the form of rescue measures having conditions built into them – conditions which would induce financial institutions to opt for private sources of investments (rather than public sources of investment) when economic conditions return to normal.[107]

According to key findings published by the OECD, the design of competition policies in banking within several jurisdictions in Europe has undergone substantial reform at national level – with very

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[103] H Hannoun "The Expanding Role of Central banks Since the crisis: What are the Limits?" June 2010 Bank for International Settlements Publications http://www.bis.org/speeches/sp100622.pdf?noframes=1 at page 7

[104] „During the crisis, central banks had to step in to replace disrupted and dislocated funding markets. Severe tensions in interbank, foreign exchange swap and some segments of securities markets – including, lately, government bond markets – hampered the monetary policy transmission mechanism. The usual relationship between key policy rates and the rates applicable in the real economy was disrupted, and the main tool for influencing financing conditions in the real economy did not work properly." ibid

[105] ibid at page 9

[106] Organisation for Economic Co operation and Development, „ Competition and the Financial Markets" at page 10

[107] An example is provided where governments could make it un lucrative for beneficiaries to rely on public capital injections any longer than they have to – by imposing restrictions on them (restrictions such as escalating dividends or interest rates). At some point, it is further argued, private sources of equity will become more desirable; see ibid

unprecedented changes occurring over the last two decades.[108]

The recent crisis has also witnessed unprecedented levels of intervention – in terms of government intervention. The OECD'S findings also highlight the fact that competition authorities around the world have also been compelled to participate in these actions for reasons other than those related to intense time pressure for action, - whilst questions relating to the application of competition policy to the financial sector have arisen.[109]

Whilst the findings highlight the controversy generated by some who argue that competition rules should be suspended for the duration of the crisis - thus allowing regulators to focus only on the objective of safeguarding the stability of the financial system, it concludes that whether competition is desirable at all when there is a systemic crisis, is a matter which generally, is in need of clarification.[110]

## E. Conclusion

The rationale for central bank and government intervention through lender of last resort facilities and State rescues respectively, is justified where safeguards exist to ensure that such intervention does not induce increased levels of risk taking or result in undue distortions of competition. Through its provision in section 2.3 paragraph 44 of the Recapitalisation Communication, the European Commission has taken a huge step in its efforts to ensure that moral hazard is discouraged , undue distortions of competition minimised – whilst providing life lines to systemically relevant financial institutions whose problems are attributed to "inefficiencies, poor asset-liability management or risky strategies". Such life line is provided „on the condition of either a bank's winding-up or a thorough and far-reaching restructuring, including a change in management and corporate governance where appropriate." In drawing a distinction between "the treatment of illiquid but otherwise fundamentally sound financial institutions" (where viability problems are exogenously induced and also related to extreme conditions which prevail in the financial market), and the treatment of financial institutions whose endogenous problems are related to inefficiency or excessive risk- taking, such a distinction is geared towards the objectives of:

1) Remedying a serious disturbance in the economy;
2) Ensuring that measure is proportionate[111] to the challenge faced, not going beyond what is required to attain this effect; and
3) designed in such a way as to minimize negative spill over effects on competitors, other sectors and other member states."

[108]For example, in Italy since December 2005 competition policy in banking is no longer enforced by the Bank of Italy but rather by the competition authority as in all other sectors. In the Netherlands, the Competition Act of 1998 applies to the banking sector, but only since 2000. See Organisation for Economic Cooperation and Development, "Competition and the Financial Crisis" at page 12

[109]ibid at page 13

[110]"Others have instead emphasised the importance of applying strict competition rules in the current crisis as a means of ensuring a level playing field and a coordinated reaction to the crisis – as well as avoiding a futile race for subsidies between countries to attract depositors and investors. Moreover, the long-term effects of relaxing competition policy can be serious. Mergers that lead to very concentrated markets in particular are almost impossible to reverse."; ibid

[111]According to paragraph 38 of the Commission's Communication on Recapitalisation "The extent of behavioural safeguards should be based on a proportionality assessment, taking into account all relevant factors and in particular, the risk profile of the beneficiary bank. While banks with a very low risk profile may require only very limited behavioural safeguards, the need for such safeguards increases with a higher risk profile. The proportionality assessment is further influenced by the relative size of the capital injection by the State and the attained level of capital endowment."

- in line with the general principles which constitute the basis of State aid rules of the Treaty (Article 87 EC Treaty and Article 107 TFEU (ex Article 87 EC Treaty).

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