EU Bank Packages: Objectives and Potential Conflicts of Objectives

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Any attempt to resolve a systemic financial crisis inherently involves conflicts of objectives. In the following article, we identify and elaborate on the conflicts of objectives embodied in the EU bank packages. Building on this, we then analyze how the EU Member States and the EU institutions are dealing with these conflicts of objectives. The empirical basis of our analysis comprises the explicit objectives of the EU bank packages and the details of the bank packages of the individual Member States. Our main findings are: (1) Although much effort has been extended to ensure a harmonized EU approach, the Member States in fact enjoy great leeway in designing national bank packages, which leads to competitive distortion. (2) In the conflict between fiscal objectives and micro- and macroeconomic objectives, the latter have been afforded priority. The bank packages entail passing on the costs of overcoming the crisis to the taxpayers, while the banks' creditors are not required to make a contribution. (3) As a result, short-term financial stability is favored over long-term stability in the conflict between these two objectives. (4) Some attempts have been made to resolve these conflicts of objectives by attaching conditions to state aid. Our analysis indicates first of all, that under certain circumstances conditions such as dividend restrictions, state influence on company management and salary caps may be consistent with all of the objectives specified, and second, that requirements to maintain lending and solve borrowers' debt problems are themselves subject to unavoidable conflicts of objectives.

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All bank rescue plans, regardless of design, are invariably subject to conflicts of interest. Thus, decisions on balancing the objectives have to be made (Mayes, 2004, p. 545). These objectives represent a variety of economic policy goals, many of them conflicting with respect to the implementation of the bank packages. This study examines the types of conflicts of objectives inherent in the structure of the bank packages of the EU Member States and how these conflicts are resolved.

Since the fall of 2008 the financial crisis that erupted in the U.S.A. in 2007 has been leading to massive financial market distress in the EU as well. The Member States interpreted this situation as an economic policy challenge to be met at the national level within a joint framework.

A concerted plan of action was resolved in a declaration by the euro area countries[2] at their summit on October 12, 2008, aiming at:

– Facilitating the funding of banks: The Member States are to guarantee new short- and medium-term (up to five years) bank senior debt issuance. Such guarantees are to be made available at market conditions (including possible further conditions) to all financial institutions operating in the country in question that meet the regulatory capital requirements and other non-discriminatory objective criteria. The scheme will be temporary (until December 31, 2009) and limited in amount.
– Providing financial institutions with additional capital so as to ensure the

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[2] *The declaration was also adopted by the European Council on October 16, 2008.*

financing of the economy by sound institutions and allowing for the recapitalization of distressed banks: Tier 1 capital will be made available to financial institutions, with price conditions taking into account the market situation of each involved institution; additional restrictions may also apply. The failure of systemically important financial institutions should be avoided. In so doing, the interest of taxpayers should be observed and it should be ensured that existing shareholders and management bear the due consequences of the intervention. Recapitalization should be followed by a restructuring plan.

Moreover, the euro area countries welcomed the actions taken by the European Central Bank (ECB) to support the interbank money market and announced that flexibility in the implementation of accounting rules will be ensured. These initiatives were preceded on October 7, 2008, by the ECOFIN Council's resolutions to raise deposit guarantee protection to at least EUR 50,000 and to guarantee that deposits are reimbursed up to the coverage level without a deductible.

The euro area countries also called upon the Commission to continue to apply flexibility in state aid decisions; taking into account the ECB's relevant recommendations, the Commission provided guidance on state guarantees and recapitalizations (see relevant sections).

In this article, we analyze the potential conflicts of objectives emerging in the Member States' implementation of bank packages to strengthen bank refinancing and to recapitalize banks.[3]

1 Objectives of the Bank Packages

The official documents of the European Council, the Commission and the ECB[4] set forth the objectives that are being pursued by means of the bank packages as follows:

1.1 Microeconomic Objectives

The purpose of guarantees and recapitalizations is to assist solvent banks in overcoming temporary problems related to the unusual business climate and to enable them to maintain sound businesses. The failure of systemically important financial institutions is to be avoided.

1.2 Macroeconomic Objectives

Apart from safeguarding the short- and medium-term stability of the financial system, including guarding against systemic effects of insolvencies, the overriding macroeconomic objective is to ensure the financial system's capacity to fund the economy.

While both of the aforementioned objectives are aimed at averting the direct consequences of the crisis on financial institutions and the financial system, economic policymakers must consider how any such intervention can be financed, its long-term effects on the financial sector and the impact of any action on other economic sectors; therefore, a number of additional objections have been stipulated.

[3] *At the time of writing, the possibility of taking over impaired assets as resolved by the European Council on March 19 and 20, 2009, was still in the early stages of implementation and has therefore not been taken into consideration.*

[4] *See Summit (2008), EC (2008b), ECB (2008b). In accordance with their respective mandates, the European Commission emphasizes objectives relating to a level playing field while the main emphasis of the ECB is on financial stability and safeguarding the single monetary policy.*

1.3 Fiscal Objectives

The European Council has emphasized the importance of considering the interests of the taxpayers; this implies the objective of minimizing the losses resulting from aid packages and ensuring adequate revenues.

1.4 Safeguarding Market Integrity

Shareholders and management should bear the due consequences of the intervention in order to prevent state assistance from abetting moral hazard and to provide incentives for a return to normal market conditions – and thus long-term financial stability – after state intervention has ceased.

1.5 Safeguarding the Level Playing Field, Avoiding Market Distortion

Implementation of the national bank packages entails the risk of competitive distortion between banks in different Member States and, as a result, the risk of a "subsidy race," along with competitive distortion between sound and instable banks and competitive distortion between banks receiving public assistance and institutions opting for capital market financing. All of this should be avoided wherever possible.

Aside from economic objectives, ensuring the political legitimacy of state action to stabilize the banking sector is another important goal that governments must consider when defining and implementing plans of action.

The study at hand identifies the types of conflicts of objectives inherent in the structure of the bank packages designed to achieve the goals described and examines how these conflicts are resolved in the following areas: action to strengthen the interbank market (section 2.1) and medium-term refinancing (2.2) as well as capital (2.3) and that related to conditions for providing guarantees and additional capital (3).

2 Common Framework, but Variations in Implementation of Bank Packages by the EU Member States

The sets of measures already approved in the EU correspond in essence to the agreed framework. Most EU Member States have included recapitalization and refinancing measures that are essentially based on similar (general) principles and involve similar access requirements, beneficiaries and terms. The packages also exhibit major similarities on an abstract level in terms of the instruments applied and the general requirements. With respect to their specific design and practical implementation, however, the differences are considerable.

19 EU countries have introduced packages to refinance banks, with 17 of them explicitly providing for the possibility of reinforcing banks' capital base.[5,6] The Member States have earmarked a total of some EUR 2.8 trillion, or 22% of the EU's GDP, for these measures. Some EUR 300 billion of this amount will be made available for recapitalizing banks and approximately EUR 2.5 trillion for state guarantees of liabilities (as of mid-March 2009). The Austrian bank package is more extensive than the average EU package,

[5] *Two countries (Belgium and Luxembourg) have taken discretionary action to refinance/recapitalize specific institutions without introducing bank packages. It should be noted that the plans are being adapted on an ongoing basis as the crisis develops, and many countries still have to work out the details.*

[6] *Three countries (Spain, Greece and the U.K.) have introduced additional asset relief programs. Other EU countries also implement asset relief measures to stabilize banks in certain cases.*

amounting to EUR 90 billion (not including EUR 10 billion in deposit guarantees) or approximately 32% of GDP.

2.1 Measures to Strengthen the Interbank Market

The financial crisis hit the euro interbank market earlier than the EU bond market or the stock markets – specifically, as early as on August 9, 2007. Interest rates on unsecured interbank loans (e.g. relative to secured interbank loans in the form of securities repurchase agreements) increased significantly. Despite cuts in key interest rates, interest rates on unsecured interbank loans remained high compared to those on secured interbank loans due to the high premiums charged on unsecured interbank loans, i.e. the short-term yield curve remained historically very steep. At the same time, both market liquidity and the maturity terms of interbank loans actually granted decreased significantly. After the collapse of U.S. investment bank Lehman Brothers in mid-September 2008, the interbank market came to a virtual standstill. In order to facilitate short-term refinancing for banks, the euro area countries proposed state guarantees for short-term bank liabilities with maturities of up to 12 months in the declaration on a concerted European action plan of the euro area countries of October 12, 2008. The bank packages of the Member States include five models for applying such guarantees:

1. State guarantees for existing and newly issued short-term securities as well as interbank loans and wholesale deposits (e.g. Denmark,[7] Ireland);
2. State guarantees for new issues of short-term securities and new interbank loans (e.g. Belgium);
3. State guarantees for new issues of short-term securities (e.g. commercial paper), but not for interbank loans (e.g. Germany, Sweden);
4. Exchanges of government bonds in return for bank receivables (asset swaps) in order to increase banks' collateral eligible for ESCB tender operations (e.g. Greece, Italy);
5. Clearinghouses (with state guarantees) for the interbank market (e.g. Austria, Italy). Since this instrument for strengthening the interbank market is somewhat more complex than the others and is particular to Austria, it is described briefly in box 1; it is also an issue of focus in the following analysis.

[7] *However, the participating banks must bear a portion of the losses of up to DKR 35 billion. Denmark has revised its original bank package in the meantime.*

Box 1

The Oesterreichische Clearingbank AG (OeCAG)

The legal basis for the activities of the Oesterreichische Clearingbank AG (OeCAG) is set out in Article 1 paras 1 to 3 of the Interbank Market Support Act (Interbankmarktstärkungsgesetz, IBSG, published in Federal Law Gazette I, No. 136/2008). The OeCAG is owned by Austria's main banks, with the various sectors being represented by their top institutions. The shareholder interests were negotiated ex ante. The operating business of OeCAG is carried out by Oesterreichische Kontrollbank AG. OeCAG has shareholders' equity of EUR 180 million. Its business volume is limited to a maximum of EUR 10 billion, although this may be increased following an evaluation phase. The OeCAG's deposit and lending business is open to all banks and insurance companies; there are no restrictions on subscribing to OeCAG's issues.

The business model of OeCAG is based on reflecting the interbank market, i.e. the OeCAG does not carry out any maturity transformations. Funds may be provided in the form of deposits from participating banks or by OeCAG's own securities issues. Bids for deposits and loans are matched on the basis of pre-defined maturities (mostly 3 or 6 months) in regular auctions in which both market sides enter their price/quantity bids. Allotments are made only when bids for loans can be matched with bids for deposits. Any issue proceeds collected by OeCAG are distributed among the shareholder banks, with 50% being allocated on the basis of shareholders' equity and 50% via auction.

Until December 31, 2009, when issuing short-term securities, OeCAG may arrange for the Austrian government to assume liability as guarantor and payer up to an aggregate amount of EUR 5 billion. A maturity cap of one year applies to the issues. The Austrian government has also pledged to cover loan defaults of up to EUR 4 billion in the event that loan defaults by borrowers cause OeCAG's regulatory capital to fall below the legally required level. In such cases, the government will provide sufficient equity capital to ensure that the 8% minimum is reached, provided the clearinghouse assigns the loan defaults to the government. The OeCAG must provide its services at market prices. The additional guarantor fee for government backing is 50 basis points, which are added to the loan interest rate.

Microeconomic objectives

The microeconomic objective of short-term refinancing was to reopen banks' access to the market for unsecured interbank lending. At the European level, these measures were successful to the extent that banks were once again able to borrow larger amounts over longer maturities. In Austria, as of mid-March 2009 the OeCAG had deposit bids of EUR 18.6 billion compared with loan bids of EUR 22.2 billion, with the amount allotted totaling EUR 5.1 billion (22% of the loans bids). The liquidity risk of Austrian banks has declined since the introduction of the bank package.

Macroeconomic objectives

The macroeconomic objective (ending the turmoil in the interbank market) has only been partially fulfilled. Even though liquidity and maturities have risen somewhat, they still have not reached pre-crisis levels. The yield curve also continues to indicate significant market disruption,[8] and so do the above-average amounts deposited by European banks at the ECB even though this involves high opportunity costs.[9]

[8] *In March 2009, the spreads between the three-month EURIBOR and the three-month overnight index swap or the three-month EUREPO were still much wider, and maturities for unsecured interbank loans were considerably shorter than before the financial crisis erupted (ECB, 2009a, p. 27). Since March the situation in euro money markets has improved further.*

[9] *The interest rate differential between deposit facilities and the minimum bid rate was usually 100 basis points. The spread narrowed to 50 basis points in the period from October 15, 2008, to January 21, 2009.*

Why have banks accepted these opportunity costs despite the fact that state guarantees have virtually eliminated credit risk?

The action taken by EU Member States to strengthen the interbank market has focused on credit risk in the interbank market while disregarding the liquidity risk of banks. To hedge this risk, they maintain liquid funds to be able to cover any net outflows. In a functioning interbank market, credit institutions are also able to obtain refinancing via unsecured loans if necessary, which can represent a form of insurance. In the course of the financial crisis, the maturity transformation of banks has risen while the interbank market has largely forfeited its function as an insurer. Liquidity risk has thus risen considerably for banks – a situation that has not been taken into account in action to strengthen the interbank market.[10] The effectiveness of such action could be increased by taking liquidity risk into consideration (e.g. maturity transformation by the OeCAG).

Fiscal objectives

The fiscal objectives of the bank packages focus on minimizing taxpayer losses and ensuring adequate revenues. The ECB recommendations of October 20, 2008, (ECB, 2008b) call for a guarantee fee of 50 basis points for short-term liabilities; all Member States have implemented this recommendation. However, to date there are no known defaults in the area of short-term refinancing. Since the Member States have agreed not to allow any systemically important banks to become insolvent, they would provide additional capital to and/or nationalize the banks before any guarantees were called upon. The fee for short-term guarantees is risk-independent, therefore the guarantee scheme involves implicit transfers from the government to banks with above-average risk exposure. By contrast, a risk-based guarantee fee would result in a high administrative burden by requiring regular risk assessments of all banks receiving state guarantees; a higher guarantee fee that better reflected market prices during the crisis would make short-term refinancing of banks more expensive. In other words, there is a conflict of objectives between the fiscal objectives on the one hand and the microeconomic and macroeconomic objectives on the other that has been interpreted to the disadvantage of the former in the pricing of guarantees.

Safeguarding market integrity

To reach this objective, the measures would have to be designed to prevent future problems resulting from adverse incentive structures. In those bank packages in which new and/or existing interbank loans are guaranteed, however, there is a risk that wrong incentive structures could impair long-term financial stability: Banks are able to nationalize potential losses ensuing from their investment decisions, which distorts incentives aimed at risk-revenue optimization. This could undermine the future effectiveness of market discipline in the interbank market, which would have a detrimental effect on long-term financial stability. Based on these considerations and for the pur-

[10] *The ECB estimates that only approximately 50% of the sharp widening in the spread between the interest rate on unsecured interbank credit with a maturity of three months (three-month EURIBOR) and the interest rate on secured interbank credit with the same maturity (three-month EUREPO) can be explained by credit risk. The remaining 50% is attributable to increased liquidity risk (ECB, 2008c, pp. 144–149).*

pose of safeguarding the single monetary policy, the ECB spoke out against state guarantees for interbank loans in its recommendations, although not all Member States committed themselves to this. However, if state guarantees are seen as the only remedy in an acute crisis situation, this could result in a conflict of objectives between short-term (strengthening confidence) and long-term financial stability.

Within the framework of OeCAG, the state is only second in line as guarantor after the OeCAG's shareholders' equity, which is paid in by the banks and acts as a safety buffer to absorb loan defaults. This largely prevents moral hazard.

Safeguarding the level playing field, avoiding market distortion

This objective would be achieved if the bank packages did not lead to national discrimination and segmentation of the money market and banks with similar risk profiles from different Member States were to pay the same money market interest rates. A joint European approach to improving short-term financing – e.g. a European clearinghouse for interbank loans – could have served two purposes: strengthening the European interbank market and restoring the level of integration existing up until July 2007. Since there is no central EU budget to back up the necessary guarantees, it was decided that short-term issues and interbank liabilities be covered by state guarantees. This could lead to a segmentation of the euro money market (ECB, 2009b), which had been almost completely integrated prior to August 2007. All EU Member States restrict the issuance of guarantees to credit institutions active in the country in question, which necessarily involves a certain amount of discrimination and segmentation in the money market. Banks with similar risk profiles from different Member States must expect to pay different money market interest rates. This is a consequence of varying market estimations of the credit quality of the individual EU Member States (as also expressed in the interest rate differentials between the government bonds) and is largely independent of the organizational structure of the national measures to boost short-term refinancing (clearinghouses or state guarantees). The goal of avoiding market distortion is thus in conflict with the microeconomic and macroeconomic objectives of stabilizing the banking system in the short term and was given a lower priority in the guarantee packages.

Due to its structure, the clearinghouse model was especially criticized as contributing to distortion in European interbank markets as well as to the disintegration thereof (Buiter, 2009). The Austrian Interbank Market Support Act, however, does not limit participation in the OeCAG's deposit business to domestic banks or insurance companies, meaning that no competitive distortion occurs in the interbank euro market and foreign banks are not discriminated against.

Moreover, experience in Austria shows that especially small banks, i.e. those banks that have only limited access to the euro money market or to the ESCB's open market operations, turn to OeCAG for refinancing. The allotted amounts are very low compared to the euro money market. In addition, the maximum amount of outstanding loans is limited to EUR 10 billion, making the implications of the Austrian approach negligible for the euro money market. Most of the funds are allotted by auction. Furthermore, guarantee fees must be paid for interbank loans processed via OeCAG. The price formation process reduces any distortion of the euro money market. In addition, the deposits with OeCAG are not guaranteed directly by the state, meaning that the depositing banks must meet the relevant capital requirements for interbank deposits. This can even result in a competitive disadvantage for Austrian banks compared with banks whose interbank deposits are guaranteed by the state directly. The action taken in Austria to boost short-term refinancing is therefore largely compatible with the objectives of safeguarding the level playing field and avoiding market distortion.

Since the pricing of state guarantees for short-term liabilities (commercial paper or interbank loans) is quite uniform in the EU (ECB, 2008b), this does not result in any competitive distortion.

2.2 Measures to Boost Medium-Term Refinancing

Refinancing costs in the bond market have been rising rapidly for banks since August 2007. Hoping for narrowing spreads, many banks strove to postpone some of their debt issues in favor of refinancing via alternative sources (e.g. private placements, short-term securities and interbank loans). However, this led to an increase in maturity transformation and thus higher liquidity risk (ECB, 2008d). After the collapse of Lehman Brothers, this contributed to banks finding access to the bond market to be as impaired as access to the money market. All of the bank packages therefore include measures to boost medium-term refinancing.

Most Member States that have launched bank packages guarantee new issues of unsecured bank bonds with maturities of one to three or one to five years.[11] Only Ireland and Denmark also guarantee secured and unsecured bank bonds that were issued before the bank packages were established. Spain has additionally set up a fund that can purchase securitized bank loans.

Microeconomic objectives

The main microeconomic objective was to restore banks' access to the bond market, which the state guarantees succeeded in doing to a certain extent. By the end of March 2009, some EUR 300 billion in state-guaranteed debt issues had been placed by banks. Some banks[12] were also able to issue unsecured debt, which yielded average premiums in the euro area of 31 (AA rating) or 64 (A rating) basis points over the state-guaranteed issues (ING, 2009).[13] The state guarantees restored banks' access to medium-term refinancing. In spite of the state guarantees, however, the medium-term refinancing costs[14] are much higher and the yield curve much steeper than before the start of the crisis (ECB, 2009a, p. 34).

This also explains why banks were not able to pass on reductions in key interest rates to the full extent. A steeper yield curve can contribute to the stability of the banking system, given that ceteris paribus, a steep curve has a positive impact on the profitability of maturity transformation. However, this results in Austrian enterprises facing much higher external finance premiums (OeNB, 2009). Fulfilling this mi-

[11] *As the crisis intensified in the first quarter of 2009, a trend toward extending maturities to five years emerged in the countries with shorter maturities (e.g. Germany, the Netherlands, Austria).*

[12] *E.g. BBVA, BNP Paribas, Caixa Geral de Depósitos, Commerzbank, Rabobank, Société Générale.*

[13] *Excluding Greece, Ireland, Slovenia and Slovakia.*

[14] *The premium on the relevant swap rates averaged 143 basis points for banks with an AA rating and 155 basis points for banks with an A rating (ING, 2009).*

croeconomic objective can come at the expense of the macroeconomic objective of supplying the economy with affordable credit.

Macroeconomic objectives

At a macroeconomic level, the bank packages were aimed at providing the economy with affordable credit. At present, it is difficult to assess the measures to boost medium-term refinancing. They have, however, succeeded in preventing a decline in lending to date. At the European level, loans to nonfinancial corporations rose by 6.3% from March 2008 to March 2009 (households: 0.4%); against the fourth quarter of 2008, loan growth slowed down (nonfinancial corporations: 11.3%; households: 2.8%).[15] In Austria, the volume of outstanding loans issued to domestic nonbanks increased by 5.6% between March 2008 and March 2009 – from EUR 293.2 billion to EUR 309.6 billion – after adjustment for exchange rates. Of this amount, EUR 135.4 billion went to domestic nonfinancial corporations and EUR 118.8 billion to domestic households, with the exchange-rate-adjusted increase amounting to 7.1% and 2.4%, respectively.[16] Even after the collapse of Lehman Brothers, total loan volumes to the private sector rose by 1.8% between September 2008 and March 2009 (nonfinancial corporations 3.1% and domestic households 0.6%). Referring to refinancing costs and the balance sheet restrictions they faced, banks nonetheless continued to tighten credit standards and the conditions and terms of credit at both the EU and the Austrian level.[17] An analysis of the effect of the bank packages on lending must take into consideration any impact of the recession on demand for credit, for which reason the figures do not provide a basis for a clear conclusion regarding the supply behavior of the financial sector.[18]

Fiscal objectives

The fiscal objectives would be achieved, if the costs incurred by the state for potential future guarantee obligations were to approximately correspond to the future expected revenues from risk-based guarantee fees at market prices. According to the ECB recommendations of October 20, 2008, the pricing of credit guarantees on bank debt with maturities exceeding one year should be based on banks' CDS spreads[19] and include an add-on fee of 50 basis points (or less if collateral is provided) in order to recover the operational costs (ECB, 2008b). Actual guarantee fees are not standardized across the Member States.[20] Whether or not this is sufficient to reach the fiscal objectives depends ultimately on default rates and therefore cannot be definitively assessed at this time. However, it can be ascertained that the ECB recommenda-

[15] *See ECB (2009c, table 2, p. 20).*

[16] *Source: OeNB.*

[17] *Source: OeNB.*

[18] *Decreasing investment activity can lead to a decline in refinancing demand. In Austria, however, there were substitution effects between possible sources of refinancing, e.g. higher credit demand as a consequence of more difficult capital market financing (OeNB, 2009).*

[19] *Median five-year CDS spreads in the period from January 1, 2007, and August 31, 2008, of either the bank itself or its rating category; if no rating is available then the lowest rating category is used.*

[20] *For banks in the euro area (excluding Greece, Ireland, Slovenia and Slovakia), actual fees for state guarantees are between 57 (French bank with AA rating) and 137 (Italian bank with AA rating) basis points or 65 (French bank with A rating) and 145 (Italian bank with A rating) basis points, with an average of 86 (AA rating) and 94 (A rating) basis points (ING, 2009).*

tions of October 20, 2008, provide for a long calculation period for pricing default risk, meaning that guarantee fees are significantly below the banks' CDS spreads at the time the individual bank packages were approved. When the packages were introduced, banks' CDS spreads fell significantly, while the sovereign spreads of numerous EU countries[21] increased markedly (ECB, 2009a, p. 36).[22] This implies a transfer of risk from bank shareholders to taxpayers that – according to market estimation – was not adequately priced into the guarantees. The conflict of objectives that exists in principle between fiscal objectives on the one hand and microeconomic and macroeconomic objectives on the other is difficult to avoid in the case of bank packages, since their whole purpose is to distribute (potential) banking system losses such as to prevent them from endangering financial stability. Therefore, the main question is who will ultimately bear the losses; the European approach imposes a particularly high share of the losses on taxpayers.

Safeguarding market integrity

The bank packages are meant to ensure that long-term financial stability not be undermined, e.g. by reducing the effectiveness of market discipline. However, some countries provide explicit guarantees for existing bond issues from national banks, thus protecting bondholders against the potential negative consequences of their investment decisions. Apart from that, in all EU countries, bondholders of systemically important banks are implicitly protected against defaults, since the EU countries have agreed that no systemically important banks should be allowed to enter bankruptcy. Thus, the effectiveness of market discipline in a central refinancing market is reduced, which could have negative long-term effects on financial stability. For this reason, numerous economists (including Zingales, 2008) have recommended mandatory debt-for-equity swaps relating to outstanding bonds. This would considerably accelerate the deleveraging process, as debt would be reduced and equity increased. In addition, this measure would be compatible with the microeconomic objective of strengthening confidence and safeguarding short-term financial stability. Furthermore, Zingales assumes that bondholders would also benefit since they would then be creditors of a bank with lower debt and higher equity. Other economists (including Santomero and Hoffman, 1998; Mayes, 2004; Bulow and Klemperer, 2009) proposed restructuring and winding down insolvent banks as alternative models that would have led to a reduction in the fiscal burden given that bank creditors (e. g. bondholders) would also contribute to distribution of the burden. A sound framework facilitates such alternative models for reorganizing and winding down insolvent banks (BCBS, 2002) but does not yet exist in Europe (Brouwer et al., 2003; Hadjiemmanuil, 2003). A conflict of objectives arises between ensuring long-term market integrity (incentive compatibility) and short-term stability (confidence) if state guarantees are seen as the only alternative in an acute crisis situation. The two objectives are regarded as compatible in alternative models of distributing the financial burden. The fiscal objectives and the objective of safeguarding market integrity prove to coincide, since

[21] *E.g. Austria, Italy, Greece, Portugal, Ireland, Spain.*

[22] *Some of the CDS spread increases and rating downgrades are attributable to the economic stimulus packages and the fiscal effects of the economic crisis.*

bondholder participation in losses would significantly reduce fiscal costs. The bank packages resolve the conflict of objectives to the detriment of long-term financial stability and fiscal objectives.

Safeguarding the level playing field, avoiding market distortion

With respect to this objective, the bank packages could be classified as successful if the refinancing costs in the bond market were similar for banks with similar risk profiles. In spite of the ECB recommendation on guarantee pricing, there are still variations between the Member States. Guarantees are most expensive in the U.K. due to the calculation period selected. Originally, the calculation period extended from October 8, 2007, to October 7, 2008. This resulted in considerably higher guarantee costs for U.K. banks, since the calculation period only included the months during the crisis (including the Lehman crisis). By contrast, the ECB recommendation included the eight months prior to the crisis (with exceptionally low CDS spreads), but not the months immediately before and after the Lehman crisis (with exceptionally high CDS spreads). As a result, the U.K. pushed back its calculation period to extend from July 2, 2007, to July 1, 2008, which resulted in a drop in the average fee by 22 basis points (ING, 2009). U.K. banks nonetheless have to pay a guarantee fee an average 10 basis points higher than that proposed in the ECB recommendation or that charged by other Member States. Italy also deviated from the ECB recommendation to the detriment of the banks requiring state guarantees, charging them an extra 50 basis points for maturities exceeding two years. Guarantees cost the least in France. The fixed premium in France amounts to only 20 basis points rather than the 50 recommended, which results in much lower refinancing costs for French banks.[23] In addition to the guarantee fees, institutional processing of the guarantees apparently also plays a role. Some countries (e.g. France) issue debt via a (partly state-owned) specialized lending institution, from which the banks can then obtain refinancing. Paper issued by the partly state-owned specialized lending institution enjoys a refinancing advantage in the market compared with state guaranteed bank bonds. In addition, the Eurosystem applies a lower haircut on these bonds provided they are delivered as collateral, which has a positive impact on the refinancing costs of French banks. Despite the joint EU basic principles, a level playing field could not be forced, since this objective might conflict with the microeconomic and macroeconomic objectives, i.e. there could be relevant differences between the banks and the banking systems of the Member States (e.g. exposure to toxic assets). Ultimately, the bank packages give priority to these microeconomic and macroeconomic objectives as opposed to the objective of ensuring a level playing field.

2.3 Measures to Strengthen the Capital Base

As a consequence of the financial crisis, the probability has increased that financial institutions will suffer losses to such an extent that their capital could

[23] *See EC (2008c). Prior to the end of February 2009, the average premium charged on the corresponding swap rate (including the full guarantee fee) for French debt issues (via the partly state-owned specialized lending institution) amounted to 72 (AA rating) and 80 (A rating) basis points, while the average for the euro area was 143 (AA rating) and 155 (A rating) basis points (ING, 2009). The fee structure in Finland is also different, given that the fixed premium for mortgage bonds is only 25 basis points (EC, 2008d).*

fall below minimum regulatory requirements. At the same time, in view of uncertainty regarding the quality of banks' balance sheets, investors expect banks to have stronger capital buffers.

To avoid insolvency, at-risk financial institutions must either attempt to reduce their risk-weighted assets and/or raise fresh capital. A capital injection can come from existing or new shareholders, by swapping debt for equity (through negotiations with creditors or by government order), or via merger with or acquisition by another financial institution. However, the capital market has suffered a general loss of confidence due to the financial crisis, with most financial institutions having become much less attractive as expressed in falling share prices and rising insurance premiums (CDS spreads) for banks' liabilities. For this reason, since the fall of 2008 financial institutions wishing to raise capital in the market have either been faced with high costs of capital or have found that they no longer had access to the capital market.

By mid-February 2009, the Member States had offered recapitalization funds totaling EUR 300 billion on the basis of the agreement concluded in October 2008 to provide tier 1 capital in order to ensure the proper financing of the economy through solvent banks and to prevent instable banks from collapsing. The volume of funds made available varies considerably between the Member States offering recapitalization plans, with Italy providing 0.7% of domestic GDP and Ireland and Austria 5%.

In most cases, preference shares[24] (usually nonvoting shares) or other hybrid instruments are offered as the preferred instrument meeting the conditions for tier 1 capital, sometimes with an option to convert them into ordinary shares.[25] Subordinated bonds[26] may also be offered. Differences exist between yield requirements, repayment modalities and redemption rules of the various countries and the affected institutions. The level of available information is not sufficient to enable a detailed analysis. Apparently, the microeconomic interest of the affected institutions in confidentiality collides with the goal of avoiding competitive distortion and ensuring the legitimacy of the bank packages in light of their fiscal implications.

In some cases, banks have been (partially) nationalized[27] on the basis of the legal framework of the bank packages. Some countries have also provided for the possibility of assuming control of banks against the will of the owners.[28]

Microeconomic objectives

Recapitalization is intended to strengthen the capital base of banks and/or their capacity to absorb losses. Since the fall of 2008, market expectations relating to the capital base of banks have exceeded the regulatory requirements to an unusual extent. At the same time, write-offs of bad securities and loans are rising. In this climate, state capital injections have led, roughly speaking, to an increase or stabilization of the level of bank capital (source: Bloomberg).

Most bank packages provide for buying preference shares, in some cases including the possibility of converting them into ordinary shares or other

[24] *Germany, France, Greece, the Netherlands, Sweden, Spain, the U.K. and Hungary.*

[25] *E.g. Ireland.*

[26] *Finland and Italy.*

[27] *E.g. Anglo Irish Bank, Fortis, Kommunalkredit, Lloyds-HBOS, RBS.*

[28] *E.g. Germany, Austria, Sweden.*

financial instruments at a later time. This instrument largely preserves the existing shareholder structure and management. The appropriateness of this approach rests on the assumption that the affected institution is in distress through no fault of its own. Market actors have different assessments regarding the classification of this instrument as tier 1 capital, since preference shares do not have all of the typical features of true equity (share capital), e.g. with regard to profit sharing and voting rights arrangements. Thus, the extent to which preference shares are a suitable instrument for increasing the stability of the supported institutions remains to be seen (Carmel, 2008).

Macroeconomic objectives

Capital injections for banks were intended to restore the banks' capacity to extend credit. The objective of maintaining lending flows (the degree of achievement of which was already discussed in section 2.2) collides with the objective of requiring – sometimes large-scale – deleveraging and minimizing risk in the banking book made necessary by the recession. Therefore, explicit requirements are needed in order to ensure that recapitalization will benefit the macroeconomic objective of maintaining lending. There is also a strong contrast between the macroeconomic objective of preserving lending and that of safeguarding financial stability. The objective of preserving the stability of the financial system has thus far been achieved insofar as no systemically important bank has become insolvent (even though some had to be nationalized in order to prevent this).

Fiscal objectives

According to the ECB recommendations (ECB, 2008a), capital injections provided by the state to sound banks should carry an average rate of return on subordinated debt of 6% and an average rate of return on ordinary shares of 9.3%. For the hybrid capital forms used most frequently, this means that the average rate of return will be somewhere within this corridor, depending on the features of the relevant instrument, including redemption and repurchase conditions.

The European Commission approves state aid based on these recommendations for setting the initial price and recommends using step-ups and repayment clauses over the term of the aid to create incentives for swifter termination. When private investors participate in the capital injection at a rate of at least 30%, the price can be reduced (e.g. in Austria from 9.3% to 8%). According to the European Commission, the recapitalization of weak banks should be subject to higher compensation and stricter requirements (EC, 2008b).

The use of instruments that boast the features of debt securities and therefore are likely to yield comparatively secure returns satisfies the objective of ensuring that taxpayer interests are protected and budget resources are used prudently, as the higher risk of capital loss related to the use of ordinary shares is avoided. This lower risk is gained, however, at the cost of forfeiting any direct influence on management, which entails other risks as detailed in the next section.

It is difficult to judge the quality of the measures from a taxpayer perspective due to a lack of sufficient information on the pricing of specific recapitalization measures and the fact that any pricing variations must be considered in the context of the overall features of the package in question.

Box 2

Participation Capital in Austria

The Financial Market Stability Act (FinStaG) makes it possible for the Federal Minister of Finance to strengthen banks' equity base by taking up participation capital.[1] In the case of sound banks, the federal government requires a dividend of at least 9.3%. If repayment is made with a return on capital of 110% or private investors contribute at least 30% to the capital injection (with a maximum of one-third coming from current shareholders and at least two-thirds from third parties), the dividend may be decreased to 8%.[2] In such a case, the restriction on dividend distribution to a maximum amount of 17.5% of distributable profits before allocation toprovisions does not apply. For distressed banks, the dividend must amount to at least 10% and no dividends may be paid to other shareholders. Similar to comparable initiatives in other Member States, the Austrian program is geared toward offering banks capital at better conditions than prevailing market rates, as these rates are considered to be too high, i.e. an expression of market distortion. At the end of 2008, the European Commission determined a market price for capital of 15% in the autumn 2008 (EC, 2008b). This can be taken as a referencefor an approximate calculation of the subsidy share of the state aid extended. If the sum of EUR 15 billion made available by the Austrian government for participation capital is provided to sound banks in the full amount at a dividend of 9.3%, banks would save EUR 855 million per year (in terms of the difference between the dividends demanded and market compensation).

[1] See https://www.bmf.gv.at/Finanzmarkt/ManahmenpaketzurSic_9175/bStrkungundStabilis_9177/Partizipationskapital/_start.htm

[2] This provision appears to allow interpretations that deviate from its substantive meaning, as shown by the reciprocal subscription of hybrid capital and participation capital by Erste Bank and Wiener Städtische Versicherung (see http://www.nachrichten.at/nachrichten/wirtschaft/art15,139210 from April 4, 2009).

Safeguarding market integrity

Although some emergency measures have involved nationalization (see footnote 27), the EU countries, in their joint undertakings, have preferred recapitalization and allowing the affected institutions to preserve their private-sector independence. This is because the provision of capital by the government stands in contrast to the economic policy paradigm dominant in the EU according to which state ownership in the banking sector is seen as an inferior corporate governance model and isolated cases of state ownership are considered as undesired competitive distortion. For this reason, governments chose largely passive instruments as recapitalization measures, i.e. instruments that comply with the definition of tier 1 capital but keep government influence on management to a minimum while at the same time being less risky than ordinary shares.

Recapitalization assistance also includes incentives to minimize the duration of government involvement. According to the current state of knowledge, repayments are usually stipulated at nominal value, with some of the repayment agreements including clauses providing for conversion of hybrid capital into ordinary shares[29] or repayment in excess of the nominal amount[30] if repayment is not made within a certain period (between two and five years).

[29] E.g. Finland, France, Greece.

[30] E.g. Ireland, Italy.

Governments attempted to compensate for the waiver of control rights, which usually come along with capital injections, by attaching conditions to the award of capital (see detailed explanation below). This represents a concession to shareholders[31] based on the assumption that any loss in value of assets would be an expression of unjustified, temporary market distortion and not the consequence of a lack of good corporate governance.

In making nationalization an option of last resort and preserving private ownership, the public sector is faced with considerable principal-agent problems with respect to limiting risk and steering economic policy.

The objective of safeguarding microeconomic autonomy is thus given priority over the objective of market integrity.

Safeguarding the level playing field, avoiding market distortion

The recommendations of the European Commission are aimed above all at preventing competitive distortion. In its Communication of October 25, 2008, (EC, 2008a) on managing the current financial crisis, the European Commission specified principles that must be met by Member States when implementing measures to support financial institutions in order to comply with EU state aid rules. Guarantee schemes must be non-discriminatory; their duration must be limited and their scope clearly specified and limited; the private sector must make an appropriate contribution; the schemes must stipulate adequate behavioral constraints for beneficiaries, and an appropriate follow-up must ensue in the form of structural adjustment measures. However, the fact that the affected financial institutions have different risk profiles, coupled with their varying degrees of success in dealing with regulators, has resulted in differences in the volume and pricing of recapitalization measures. In some cases, the European Commission has responded to this situation by requiring adjustments to be made, which has resulted in delays in approving the applications submitted. In this case, the objective of avoiding competitive distortion conflicts with micro- and macroeconomic objectives, but contributes to reaching fiscal objectives given that it serves to prevent "competitive subsidization."

3 Conditions for Guarantees and Capital

Attaching conditions to state aid for banks serves as a central instrument for achieving the economic policy objectives specified in section 2. The debate on the political legitimacy of bank packages also focuses on the extent and the stringency of conditions linked to state aid for the financial sector. In many of the Member States, the bank packages include some of the following five conditions.

3.1 Lending Requirements

The central motive and aim of state intervention in the banking sector is to maintain the intermediation function of the banking sector and to keep credit flowing to businesses and households. In some countries, this aim is to be achieved by requiring banks to fulfill specific conditions: 11 Member States[32] require beneficiary institutions to commit to providing loans in return for

[31] *No dilution of existing shares, in return for which the capital provided by the state will only be used to cover future potential losses after the share capital has been exhausted.*

[32] *Denmark, Germany, Finland, France, Greece, Ireland, Italy, Austria, Portugal, Slovenia and the U.K.*

receiving state aid, with the extent of the obligation differing in the various Member States.

3.2 Dividend Restrictions

Dividend restrictions are intended to prevent banks from distributing funds to shareholders while making use of state aid. Eight Member States[33] provide for the possibility of dividend restrictions in their bank packages.

3.3 Restrictions on Salaries and Bonuses

The bank packages of 13 Member States[34] provide for the possibility of restricting salaries and bonuses paid to executives of institutions receiving the benefit of state aid.

3.4 Obligation to Attempt to Solve Borrowers' Debt Problems

Three Member States[35] provide for the possibility of requiring institutions benefitting from state aid to offer relief for borrowers in their bank packages.

3.5 Seat on Executive Board/Voice in Management

The bank packages of seven Member States[36] provide for the government to have a say in corporate management (or a right of veto with respect to certain issues).

The following tables provide an assessment of the aforementioned requirements in terms of the various objectives specified and how such requirements have been integrated into the bank packages of the Member States, to the extent that this information is publicly available. All requirements can be regarded as contributing to the political legitimacy of state aid measures.

Assessment in terms of economic policy objectives

Microeconomic objectives

Lending requirements	Conflict with financial institutions' need to strengthen the equity base and deleverage.
Dividend restrictions	May have the unwanted effect of dissuading potential investors and putting pressure on share prices, depending on the investor structure (percentage of stable core shareholders), investor expectations (which are affected, for instance, by the role of previous dividend policy in maintaining investor loyalty) and on the general market situation (i.e. the dividend policy of similar companies). In any case, a prohibition on dividends helps banks to build up equity.

[33] *Germany, Denmark, France, Greece, Italy, Austria, Portugal and the U.K.*

[34] *Germany, Finland, France, Greece, Ireland, Italy, Lithuania, the Netherlands, Austria, Portugal, Sweden, the U.K. and Hungary.*

[35] *France, Ireland and the U.K.*

[36] *Greece, Ireland, the Netherlands, Portugal, Sweden, the U.K. and Hungary.*

Restrictions on salaries and bonuses	Free up funds for other purposes, such as building up reserves. Concerns that salary caps could make the affected institution less attractive as an employer and thus impair the quality of executive management become less relevant in a job market suffering from recession and massive layoffs in the financial sector. Moreover, since banks will be adjusting their business models, the job specifications for executive personnel in the banking sector are likely to change in comparison with the expansionary phase of recent years.
Requirements to solve debt problems	May entail losses and thus lower earnings.
State involvement in corporate management	Limits decision-making leeway for existing management. While under normal conditions, the stock market usually perceives any state involvement in management as undesirable, in times of crisis this can be interpreted as a reassuring sign. If deficient corporate governance structures have contributed to the need for the affected institution to recapitalize, state involvement can bring an improvement.

Hence, requirements to maintain lending and solve borrowers' debt problems tend to conflict with microeconomic objectives, whereas requirements to forgo dividend payments, restrict salaries and bonuses and allow state involvement in management may under certain circumstances be compatible with these objectives.

Macroeconomic objectives

Lending requirements	Involve a conflict of objectives between facilitating the flow of lending to the real economy and safeguarding financial stability.
Dividend restrictions	Are in principle suitable for preventing a misallocation of resources. To assess the macroeconomic effect, it is necessary to know the identity of the dividend recipients. If the dividends flow to households, dividend restrictions are not likely to greatly affect financial stability. However, if dividend restrictions lead to the removal of a significant source of income from systemically important institutional investors, such restrictions could have negative consequences for financial stability. Any restriction of dividends must also be viewed as a return to normal levels after the record highs seen in recent years (see ECB, 2008c, p. 82).

Restrictions on salaries and bonuses	Could bring a desired correction of a period of overpayment prior to the crisis and contribute to reshaping the financial sector as well as reducing the inflationary effects of high management salaries in the banking sector on management salaries in other industries. Caps on salaries and bonuses may also send a signal of legitimacy to other wage groups and taxpayers.
Requirements to solve debt problems	Ensure that the state aid reaches other sectors of the economy.
State involvement in corporate management	Contributes to corporate policy being geared directly to macroeconomic objectives.

From a macroeconomic perspective, requirements to maintain lending thus entail a conflict of objectives, whereas dividend restrictions, salary caps, requirements to solve debt problems and state influence on management tend to be compatible with macroeconomic objectives.

Fiscal objectives

Lending requirements	The risk that additional losses could ensue from granting new loans has to be weighed against their potential returns.
Dividend restrictions	Contribute to giving priority to utilizing net profits to compensate taxpayers (although this objective could also be attained by giving priority to coupon payments for state capital).
Restrictions on salaries and bonuses	Free up funds for repaying state aid in the short term, but complicate the process of setting medium-term salary incentives that could maximize revenue for the state.
Requirements to solve debt problems	Waiving claims would mean taking losses, while rescheduling debt would postpone returns. Indirect effects on the budget (such as effects on borrowers' capacity to pay taxes) could compensate for this, however.
State involvement in corporate management	Fiscal objectives are easier to implement when the state can directly influence corporate policy, since direct involvement improves the state's level of information and its ability to steer the generation and appropriation of income.

Hence, requirements to maintain lending and solve debt problems tend to conflict with fiscal objectives, while dividend restrictions and influence on corporate management are compatible in principle, and salary caps may be compatible with fiscal objectives under certain circumstances.

Safeguarding market integrity

Lending requirements	An assessment depends on whether the requirements effect a refocusing on sustainable business activities or a prolongation of excessive lending.
Dividend restrictions	Contribute to avoiding future moral hazard problems since they imply that shareholders are penalized for their failure to exert control in the period prior to the crisis. Forfeiting dividends when profits are lacking also corresponds with the logic of dividends as participation of the owners of capital in any profits.
Restrictions on salaries and bonuses	May be regarded as corrective intervention in corporate government mechanisms, the failure of which was brought to light by the crisis insofar as these mechanisms provided incentives for excessive risk-taking by management. Restrictions function as a signal that state aid is linked to personal losses for management, which lowers the moral hazard in future cases.
Requirements to solve debt problems	Signal banks to deal with lending in a responsible manner in the future.
State involvement in corporate management	Ensures that the state will be able to carry out the shareholder's role of supervising management. In the case of instable banks that benefit from state support, supervision of the banks' business policies is of key importance, given that incentive exists for the banks to initiate risky transactions which, if successful could save the institution but if unsuccessful could increase the taxpayers' tax burden ("gambling for resurrection").

Requirements to maintain lending are compatible with the objective of safeguarding market integrity under certain circumstances, while dividend restrictions, salary caps, requirements to solve debt problems and state influence on business policy are generally compatible with this objective.

Avoidance of competitive distortion

Lending requirements	Earmarking prevents the funds from being used to aggressively expand into other areas of business.
Dividend restrictions	The loss of relative attractiveness to shareholders of state-assisted banks on which dividend restrictions have been imposed compensates for the competitive advantage enjoyed by banks receiving state assistance over their competitors and therefore contributes to the objective of safeguarding the level playing field.

Restrictions on salaries and bonuses	Are compatible with the aforementioned objective to the extent that such restrictions create incentive for affected management members to repay the state aid swiftly.
Requirements to solve debt problems	Represent ex-post sanctions for market shares gained on the basis of unsustainable lending policies.
State involvement in corporate management	May contribute to achieving the objective if state involvement prevents state aid from being used to gain market share.

Therefore, all of the requirements specified may contribute to the objective of avoiding competitive distortion.

4 Conclusions

The EU bank packages are structured such as to entail a number of conflicting objectives, which imply distributional conflicts. The analysis at hand has identified four areas of potential conflict in particular: First, microeconomic and – to some extent also macroeconomic – objectives imply that the bank packages are designed in a way that conflicts with fiscal objectives and thus with ensuring the political legitimacy of the measures. Second, where state guarantees are seen as the only way out of the current crisis, there are often contradictions between bolstering confidence for the benefit of short-term financial stability and safeguarding market integrity and avoiding moral hazard to maintain long-term financial stability. Hence the lack of a sustainable EU framework for restructuring and winding down insolvent cross-border banks has intensified this conflict of objectives. In the EU bank packages, the objective of short-term financial stability takes priority over avoiding moral hazard in this context. The two objectives can be regarded as compatible when alternative models of distributing the financial burden are considered. The central problem in this regard is the politically motivated decision of the EU Member States to refrain from forcing bond and money market creditors to share in the losses, a policy that is also questionable in the light of fiscal target setting and political legitimacy (distributive justice). Third, the EU has decided to afford the Member States leeway to factor in the specific features of national markets and financial institutions with a view to short-term financial stability; this leads to competitive distortion between the Member States. Fourth, while microeconomic objectives such as deleveraging are consistent with the goal of market integrity and financial stability, they conflict with the macroeconomic objective of maintaining lending.

The EU has made some attempts to resolve these conflicts of objectives by attaching conditions to state aid. Our analysis indicates first of all that under certain circumstances it may be possible to reconcile conditions such as dividend restrictions, state influence on company management and salary caps with all of the objectives specified, and second, that requirements to preserve lending and solve borrowers' debt problems are themselves subject to unavoidable conflicts of objectives.

In some cases, the institutional framework of the bank packages intensifies the conflict of objectives. The decision to leave it to the Member States to implement the bank packages within a joint EU framework has led to divergence in the scope and design of the packages. While this could facilitate the achievement of micro- and/or macroeconomic objectives in the Member States, it impedes achievement of the objective of safeguarding the level playing field. A key question for future research will be whether the heterogeneity of the amounts and modalities of the bank packages is an expression of an appropriate adjustment to the different circumstances in the financial sectors of the individual Member States or rather an expression of other factors such as differences in the fiscal room of maneuver or the ability of the financial sector to affect policymaking.

The lack of transparency surrounding the implementation of the bank support measures by the Member States, for instance with regard to the pricing of state aid, contributes to maintaining the opacity that is regarded as one of the main causes of the current financial crisis; such lack of transparency is thus extremely problematic from a macroeconomic perspective.

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