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Bank restructuring in the EU: Which way to go?☆

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Abstract

We empirically analysed the costs of bank restructuring measures undertaken in the EU countries during recent global financial crisis under the state aid framework. With a unique dataset from over 80 bank case studies in 2008–2014, we modelled the determinants of bailout costs and ranked the cost of each tool applied. We have found that the most important determinant was level of capital adequacy, while the most cost-consuming tool—liquidation of a bank. Thus, our study provides implications on the selection of state aid tools and sheds a new light on their costs. Overall, we concluded that banks' higher loss absorption capacity, strengthened supervision over small and medium-sized banks and restrictive approach to diagnose bank's problems may limit the costs of future rescue operations.
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JEL classification: G21; G28; H12

"It is better to be roughly right than precisely wrong."—John Maynard Keynes

1. Introduction

Recent global financial crisis shows that the support measures undertaken by the governments were applied on an unprecedented scale and, in most cases, placed a significant burden on the

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taxpayers. The crisis spread over many EU countries, although it was the most severe in countries of Southern Europe. Problems in the banking sector began and concentrated in the "core" of the EU—the UK, Belgium, France and the Netherlands. Gradually, it also manifested in the so-called "periphery" countries, *inter alia* in Spain, Cyprus and Portugal. Banks in many countries had been conducting overly aggressive lending policies and engaged in trading risky financial instruments. Although, European banks suffered the consequences of the US subprime crisis, they also committed many mistakes in their own risk management.

Government financial assistance in the EU was granted under special arrangements. Any public aid which distorts competition by favouring certain companies or production of certain goods is incompatible with EU regulations. Certain forms of state aid were, however, excluded from this rule, *inter alia* the aid to remedy a seriously disturbed economy, but this type of support cannot be granted on a regular basis. The terms and conditions for granting it are strictly regulated. Due to the deteriorating standing of financial institutions, the European Commission issued, in October 2008, the first communication on state aid to financial institutions, followed by six communications in the following years. State aid was applied with the use of the following restructuring tools: recapitalisation, guarantees, asset relief measures and support for liquidation.

Our study covers restructuring of banks in the EU countries for the period from 2008 to 2014. Not all EU countries had to recapitalise financial institutions. Such financial support was not used in countries like the Czech Republic, Estonia, Poland and Malta. There were also other countries, such as Latvia and Lithuania, in which financial institutions were granted state aid only to a very limited extent. In total we have examined 84 cases of banks' restructuring from 17 EU countries, as well as three 'aid packages' targeting banks in Denmark. However, a full set of financial data was available for 80 banks.

Our research responds to the following questions: what are the determinants of costs of bank restructuring methods and which restructuring tools proved the most expensive? According to our knowledge, this is the first study related to the recent crisis in the EU, looking not at the total fiscal burden, but at the costs of the restructuring tools and the size of the restructured banks. In comparison to previous studies, we focus on the recent global financial crisis and use banks restructuring cases from a rather homogenous group of countries with similar regulatory frameworks. Our contribution to the literature is threefold. First, we analyse bank restructuring tools, including: the banks' size and the costs incurred. It is important due to the fact that the greatest attention was paid to dealing with systemically important banks on both global and country levels, not to the smaller banks. Second, we use a unique set of data collected from bank case studies as an alternative to the European Commission's aggregated state aid database. Third, we introduce and model a novel measure of the costs of bank restructuring which captures the systemic importance of the bank.

This article is structured as follows: following the introduction, we present the background and the motivation in Section 2. Section 3 presents an empirical analysis of the costs of bank restructuring, taking into account various restructuring tools and the size of the banks. Finally, the paper presents conclusions and policy implications.

2. Background and motivation

The need to restructure banks in the EU was caused by the worsening of their financial standing, especially the incurred losses. In more than three quarters of cases we have analysed, the restructured banks implemented, in 2006–2008, expansionary credit policies, which consequently led to the deterioration of asset quality and high credit loss provisions. Almost 40% of cases were

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