

Competition and Stability in Banking: A New World for Competition Policy?

Xavier Vives*

IESE Business School

March 2010

1. Introduction

Competition has been traditionally contentious in banking and policy has oscillated from attempts to suppress it to liberalization. This paper summarizes some of the arguments relating competition and banking instability, draws the connections between regulation and competition policy, and analyzes the role of competition policy in the banking sector in a financial crisis.¹

Competition policy in banking has been considered and implemented as in any other sector of economic activity up to the crisis. The crisis started in 2007 with subprime mortgages, becoming systemic after the demise of Lehman Brothers in September 2008, has changed this. The systemic financial crisis has overridden competition policy concerns with massive bailouts (state aid with commitments in public interventions in the EU and US) of up to 30% of GDP. The public aid programs have distorted competition and created an uneven playing field in terms of the cost of capital and perception of safety and soundness. Market power concerns on mergers have been also overruled. The result after the mergers is potentially weak competition among the players left. Those consolidations add to the recent trend of increased consolidation within countries, across countries and across business lines (e.g. forming financial conglomerates).

* Public-Private Sector Research Center and Abertis Chair of Regulation, Competition and Public Policy. This paper is a revised summary of the presentation made in Venice, at the CEPR/ESI 13th Annual Conference on September 2009, *Financial Supervision in an Uncertain World*, forthcoming at *ESI Annual Conference Report*.

¹ For a fuller assessment of the relations between competition and banking stability see Vives (2010), on which the present paper is based.

The crisis has put both regulation and competition policy in banking into question. With regard to competition policy the naïve idea that banking was like any other sector in the economy has been blown away by the massive public intervention with very high competitive distortionary potential. A first question, therefore, is how and whether to contemplate a banking sector specificity in competition policy. And if this is the case with what characteristics. A second question is whether to view regulation and competition policy as complementary or substitutable policy tools, and how they should be coordinated. More in general, the question is what should be the role of competition policy in the banking and financial sector in the new regulatory post-crisis era.

The plan of the paper is as follows. Section 2 examines the trends in the banking sector and in its regulation, taking into account the impact of the crisis. Section 3 examines the trade-off between competition and stability in banking and ponders whether we can regulate it away. Section 4 examines the competition policy response to the crisis and concluding remarks follow.

2. Trends in the banking sector and the crisis

Banking went from being one of the most regulated sectors in the economy after the crisis in the 1930s to a much more lightly regulated sector with the liberalization process started in the 1970s in the US. The first period was marked by few crises while there has been much more instability in the second one, culminating with the 2007- subprime crisis. In the first period competition was thought to be detrimental to stability and in many countries competition policy was not applied fully to the sector until recently despite the importance of the banking sector in the economy and the costs and inefficiencies induced by financial repression. Indeed, until relatively recently central banks and regulators were complacent with collusion agreements among banks and preferred to deal with a concentrated sector with soft rivalry. This changed with deregulation and the idea that competition enhances efficiency, be it productive, allocative, or dynamic (innovation). Competition policy is now taken seriously in the banking sector. In the US banking becomes subject to competition law in the 1960s with the end of its antitrust exemption. In the EU the European Commission has intervened

since the 1980s against national protectionism, mergers, price agreements, abuse of dominance, and state aid.²

Liberalization has been associated with an increase in competition faced by financial intermediaries (but bank assets have not declined in relation to total financial assets) and with an increase in the incidence of crises. At the same time, banking has transformed itself towards services provision and restructuring has tended to increase aggregate concentration (although the consequences of this may have been different in relevant retail local markets in the US and Europe). The crisis marks a return to traditional banking and tends to exacerbate the consolidation trend.

Banking and financial markets display the whole array of classical market failures, due to externalities (fragility with coordination problems and contagion), asymmetric information (excessive risk taking with agency problems, moral hazard and adverse selection), and potential market power. This has led to regulation to protect the system, the small investor, and market competitiveness. The problem is that facilities like the lender of last resort, deposit insurance and “too big to fail” policies introduce further distortions and exacerbate the excessive risk taking problem.

The introduction of competition in banking has been accompanied by checking risk taking with capital requirements, allowing banks to rely on their own internal models to assess and control risk, and including disclosure requirements for financial institutions in order to increase transparency and foster market discipline. A flexible view of capital requirements, supervision, and market discipline are the pillars of the Basel II framework. The rationale of the reformed framework was to provide more risk sensitivity to capital requirements. Supervisors would assess how well banks are matching their capital to the risks assumed and banks would disclose information on its capital structure, accounting practices, risk exposures and capital adequacy. In summary, capital requirements plus

² See Carletti and Vives (2009).

appropriate supervision and market discipline were seen as the main ingredients to maintain a sound banking system.

The present crisis is a testimony of the failure of the three pillars of the Basel II system. Disclosure and risk assessment have been deficient (think of the failure of rating agencies), and market discipline has been ineffective because of the blanket insurance offered by too big to fail (TBTF) policies. Capital regulation has not taken into account systemic effects (the social cost of failure) and assets restrictions have been lifted under the pressure of investment bank lobbies. Supervision has proved ineffective since it has allowed a shadow banking system to grow unchecked. In summary, the crisis has uncovered massive regulatory failure as well and potential contradiction between regulatory intervention and competition policy.

3. Can we regulate away the competition-stability trade-off?

Banks are unique because of their particular mix of features which makes them vulnerable to runs with potentially systemic impact and very important negative externalities for the economy. The fragility of a competitive banking system is typically excessive and financial regulation comes to the rescue at the cost of side effects and regulatory failure. The most important one is the potential moral hazard induced by protection and bail outs extended to failing institutions.

Theory and empirics point to the existence of a trade-off between competition and stability along some dimensions. Indeed, runs happen independently of the level of competition but more competitive pressure worsens the coordination problem of investors/depositors and increases potential instability, the probability of a crisis and the impact of bad news on fundamentals. This does not imply that competitive pressure has to be minimized since the socially optimal probability of a crisis is positive in general because of its disciplining effect. On the asset side, once a certain threshold is reached, an increase in the level of competition will tend to increase risk taking incentives and the probability of failure of banks. This tendency may be checked by appropriate regulation

and supervision. The evidence points to liberalization increasing the occurrence of banking crises while a strong institutional environment and adequate regulation mitigating them. At the same time, there is a positive association between some measures of bank competition (e.g. low entry barriers, openness to foreign entry) and stability.

The trade-off between competition and stability is complex but seems real (at least along some dimensions). Regulation can alleviate the competition-stability trade-off but the design of optimal regulation has to take into account the intensity of competition. For example, capital charges should account for the degree of friction and rivalry in the environment of the banks, with tighter requirements in more competitive situations. Given that fine-tuning of regulation has proved very difficult in practice (this is probably an understatement given the massive regulatory failure that the crisis has uncovered), the trade-off between competition and stability is bound to persist and it does not seem prudent to strive for the complete elimination of market power in banking. This may have implications in terms of an optimal degree of concentration, which is likely to be intermediate. The coordination of regulation and competition policy in banking seems necessary. In any case, what is clear is that competition should be limited for institutions close to insolvency. This should be done in a prompt corrective action frame where the supervisor has to intervene as red flags of depleting capital are raised.³ The uniqueness of banks, and not only in a crisis situation, should be recognized and the lessons drawn for the implementation of competition policy.

4. Competition policy in a crisis

Competition policy in banking has been geared towards avoiding anticompetitive effects in individual crisis or failures. The question is what to do in a systemic crisis where there is strong pressure to stabilize the system. In the 2008 crisis we have witnessed an array of asset purchase and guarantee schemes (including extensions of deposit insurance, and guarantees in the interbank market and in mutual funds), capital injections, outright

³ This is the idea of the US Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 in order to reduce the discretion of the regulator with intervention rules which are gradual.

nationalization and forced mergers. All this represents a tremendous distortionary potential in terms of moral hazard, long term effects in market structure, protection of inefficient incumbents and creation of an uneven playing field (among different institutions and different countries). For example, helped institutions which have proved to be TBTF may end up with a lower cost of capital than others (not only in the short term but also in the long-term because of the implicit guarantee they obtain). Ex-ante the incentives are to take excessive risk. This is compounded with subsidy races to help national champions (apparent in the EU with a threat to the single market).⁴ The aid may foster regulatory forbearance to cover losses. There is indeed evidence that regulatory forbearance is prevalent when the banking sector is weak (S&Ls, Japan's banking crisis and in emerging countries). Finally, help to banks has spillovers to other sectors (like automobiles).

State intervention and even outright ownership have been necessary to stabilize the system. Indeed, when the taxpayer is footing the bill the public sector must have a say in the running of the helped institutions. However, government ownership is distortionary: government is on both sides of the regulatory relationship; political objectives/and incentives rule; if not disciplined by competition it induces less competitiveness of the banking system, inefficiency, and less financial stability with higher risk exposure and more bank losses; it eliminates the market for corporate control; creates an uneven playing field (with implicit and explicit guarantees); and ends up inducing less competition and lower financial development.

Policy intervention in a crisis has to walk a narrow path between the support measures to avoid contagion and protect financial stability, and the desire to maintain a vigorous long-term competition. Unavoidably some trade-off between the two objectives, particularly in the short-term, will exist. When a systemic crisis strikes there is little time to react and support measures have to be implemented very quickly. Central banks, regulators and

⁴ Another dimension of state intervention is the tendency of some countries to promote a financial center. While when promoting national champions government support will tend to be distortionary, in this instance the evaluation is more complex since competition among financial centers may deliver benefits for investors.

fiscal authorities provide the support measures and the competition authority has to watch for distortions on competition (including the formation of market structures non-conducive to competition).

Help to a bank typically provides a positive externality to other banks since it limits the spread of the crisis and protects the system mostly by avoiding contagion, be it informational or because of interbank exposures. This does not distort competition if it is liquidity help that allows a fundamentally sound bank to avoid contagion and ride the crisis. If the bank is in distress but has a solvency problem then this indicates that it should be restructured and help needs to come with strings attached so that competition is not distorted with “bad” banks displacing “good” ones in the business of customers. The counterfactual for whether help is distortionary has to take into account what would have happened if there had not been coordination failure of investors from the point of view of the distressed institution. That is, extracting the panic component in market behavior. This is not an easy task, particularly when compounded by regulatory failures which induce excessive risk taking.

The main tools of intervention to limit distortions are structural (asset divestitures) and behavioral restrictions. Structural commitments may help reduce also the post-crisis overcapacity in the banking sector accumulated during the asset boom in many countries. Indeed, an added component in the present crisis is the extent of overcapacity in the banking system. The period of expansion with low interest rates has led to overexpansion of banking via credit particularly in those countries where there has been a real state bubble (e.g. US, Ireland, UK, Spain). This means that branches and personnel are to be cut together with the balance sheet of institutions even if credit is normalized (because it will stabilize below the pre-crisis bubble levels). In any case, care must be taken so that the commitments, either structural or behavioral, leave the restructured bank as a viable competitor. An important point to check moral hazard may be the removal of the management of the helped institution that has behaved imprudently. In this case the behavioral restrictions on the helped bank could be relaxed.

Interventions have taken up the form of public aid and force mergers. Let us take hem in turn.

4.1 Public help

The EU competition authority has the unique capability, among competition authorities, to control state aid. Since the crisis the EU has dealt with many banking aid cases (taking 22 decisions only in 2008 and 81 decisions as of December 17, 2009). Most of the cases (75) were approved without objection.⁵ The EU has stated conditions for state guarantees/recapitalization (EU Communications October-December 2008). Those conditions, which try to minimize the distortions introduced by public help, in particular for non-fundamentally sound institutions, have been formalized into temporary guidelines on restructuring aid to banks (EU Communication of July 2009, according to A. 87.3b of the Treaty of the EU in relation to State aid in case of serious disturbance of the economy).

The regulatory tools used are structural (with balance sheet reductions and divestitures) and behavioral (with restrictions on pricing, publicity or compensation for employees). For example, the recapitalized Dutch bank ING has been forced to shrink its balance by almost half by selling its insurance business and ING Direct US. Northern Rock was forced to split into a “good” bank, with an opening balance sheet of around 20% of the pre-crisis level, which will continue mortgage lending and deposit taking, and a “bad” bank which will hold the majority of the legacy mortgage loans of Northern Rock. Both ING and Northern Rock were required not to exercise price leadership (best deals) and not to advertise public help. RBS has been ordered to sell some retail operations, insurance, and commodity-trading business. Interestingly, for retail (and corporate banking for small and medium-sized enterprises-SME) the Commission mentions concentration concerns with RBS being the leader, while for insurance and commodity-trading business it mentions also the benefits of the divestments in terms of limiting moral hazard. Commerzbank was required to sell the real-state lender Eurohypo, and

⁵ 66 more cases have been cleared under a temporary framework to support lending to firms. DG Competition (December 17, 2009), State aid: overview of national measures adopted as a response to the financial /economic crisis.

WestLandesbank was required to sell the proprietary trading desk and restricted the banks' activity to core banking activities. Quite a few of the restructurings have implied large balance sheet reductions.

Some of the measures can be understood in order to minimize competitive distortions of the aid, others in terms of checking moral hazard in the future. In principle, the role of the competition authority is to preserve competition and not to limit moral hazard, which is the role of the regulator. The important point is that even the ones purely aimed at competitive distortions will have an impact on ex ante incentives since a bank will know that help in case of trouble will come with restrictions. This has a connection with the TBTF issue. More broadly, the concept of competitive distortion may encompass competition based on an advantage of being under the TBTF umbrella. In this sense the restrictions on lines of activity outside the regulated core banking business may make sense although they go somewhat beyond the standard competition concern and analysis.

The activism of the EU Commission poses the question of (future) competitive balance with aided US banks for which no divestitures have been required. This may prove important in particular in the segments of the banking business in which there is global competition. The Obama administration, under the advice of Paul Volcker, is advocating limits on size and scope (mostly on proprietary trading) of banks to avoid the "too big to fail" (TBTF) problem as well as controlling risk taking.⁶ What the European Commission is trying to accomplish with state aid control the US may accomplish by regulation. The important side benefit of state aid control in the EU is that it limits the incentives of bankers to take excessive risk in the expectation of a bailout if things go wrong. That is, it addresses the TBTF issue. The competition authority may internalize that if when an institution fails it gets help, competition will be distorted. To limit the size (or better the systemically-corrected size) of an institution with break ups once they receive public help (something that the EU seems to be implementing) is an option which extends the realm

⁶ See <http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e>.

of competition policy. The US so far seems to be following another route where TBTF is explicitly not an antitrust problem.

In any case, size and scope restrictions are a blunt instrument to deal with the TBTF issue. Controls on size are problematic because interconnectedness and line of business specialization are more important than size for systemic risk. With regard to the scope of the banking firm, conflict of interest is what leads to potential market failure and is the lead to indicate possible scope limitations. Higher capital and insurance charges for systemically important institutions together with effective resolution procedures may be a better way of dealing with the problem. This should be coupled with a serious consideration of conflicts of interest in financial conglomerates. The upshot is that the competition authority in its role of protecting competition may have a say in the TBTF issue and therefore its actions should be coordinated with the regulator. The potential for competition policy to provide a commitment device to partially address TBTF issues should not be dismissed.

The Obama administration move is reminiscent of the XIX century antitrust tradition of looking with suspicion large firms because of the excessive power concentration they entail. Later on antitrust evolved with size not being an offense but market power in a particular market. The influence that investment banks have had in the deregulation of financial intermediaries and the ensuing enormous increase in leverage leading to the crisis is backfiring. We are in the territory of political economy and the question is how to better control excessive concentrations of power in a democratic society.

4.2 Forced mergers

The crisis has forced mergers of institutions backed by government subsidies and/or guarantees. In the US, Bear Sterns merged in March 2008 with JP Morgan backed-up by the Federal Reserve, JP Morgan later in the year acquired banking assets of Washington Mutual from the FDIC, and Merrill Lynch merged with Bank of America (going over, together with Wells Fargo acquiring Wachovia in 2008, the 10% national market share

deposit threshold).⁷ In the UK, the merger of HBOS and Lloyds TBS was approved against the OFT's opinion (with partial nationalization) despite a 30% market share of the merged entity in current accounts/mortgages and competition problems in SME banking services in Scotland. It is worth noting that Lloyds was not allowed to take over Abbey in 2001. Lloyds also negotiated with Brussels some divestments because it received state aid in the merger process. The Commission also imposed restrictions on Commerzbank in order to complete its merger with Dresdner Bank (planned before the crisis stroke). It seems as if governments were using a broad interpretation of the "failing firm defense" doctrine, i.e. that the merger with a failed entity can not create competition problems because the assets of the firm would exit the market in case of failure, to interpret that an anticompetitive merger may be accepted to stabilize the financial system.

The upshot is that surviving incumbents increase market power and have a lower cost of capital because they are TBTF (and/or because of the public help). Here it must be recalled that merger policy affects degree of competition and dynamic incentives. The takeover of a failed bank may reward an incumbent with temporary monopoly rents, induces monopoly inefficiency but prudent behavior. This is optimal only if subsequent entry is facilitated. The danger now is that incumbents increase their market power and are protected from entry. A merger policy must have a long horizon, and even in a crisis situation, must consider the optimal degree of concentration in the industry, dynamic incentives for prudence of incumbents and the ease of entry.

5. Concluding remarks

Banking is no longer an exception in the enforcement of competition policy. This is how it should be to guarantee competitive financial input. Indeed, competition is not responsible for fragility in banking, but competition policy should recognize explicitly the uniqueness of banks, and not only in a crisis situation. The banking sector specificity

⁷ The Riegle-Neal Act (1994) prohibits any merger or acquisition that results in the combined banking organization controlling more than 10% of domestic deposits at the national level. Note, however, that a national cap on market share for deposits should not be relevant from an antitrust perspective since the relevant markets for retail and SME are local.

in competition policy should be recognized and the exception limited. This would protect competition policy in banking as well as help avoiding the extension of unconditional bailouts to other sectors.

The analysis and the evidence point to the existence of a trade-off between competition and stability along some dimensions. Regulation can alleviate the trade-off but the design of optimal regulation has to take into account the intensity of competition. Given that fine-tuning of regulation has proved very difficult in practice, the trade-off between competition and stability is bound to persist and the coordination of regulation and competition policy in banking seems necessary.

Merger policy in banking should be intertemporally consistent having in mind an optimal degree of concentration and dynamic incentives (rewarding prudence at the same time that entry is eased). Open issues are whether an extra allowance for market power or concentration should be allowed in banking and how to deal with TBTF institutions. With respect to the latter, in the US TBTF is not an antitrust issue while in the EU the competition authority controls distortions of competition which arise out of state aid and this has implications for TBTF. Controls on size are problematic because interconnectedness and line of business specialization are more important than size for systemic risk. With regard to the scope of the banking firm, conflict of interest is what leads to potential market failure and is the lead to indicate possible scope limitations.

All this calls for close collaboration of the regulator (in charge of stability and prudential control) and the competition authority (in charge of the health of competition). First of all, regulatory requirements and competition policy intensity have to be coordinated. Capital charges may have to be fine tuned to the intensity of competition in the different market segments. Second, a protocol of collaboration of the regulator and the competition authority should also be put forward. This will be particularly important in crisis situations. The competition authority has the potential to provide commitment to address TBTF problems that derive into competition distortions; the regulator should address the TBTF issue and moral hazard with systemic capital charges, effective resolution

procedures, and scope restrictions which target conflicts of interest. Finally, crisis procedures should be established delineating liquidity help from recapitalization and the conditions for restructuring to avoid competitive distortions. Entities which are close to insolvency should be tightly regulated (and its activities restricted) in a prompt corrective action frame.

The role of competition policy in a crisis situation is to keep markets open, check the distortions introduced by rescue packages, weed out inefficient institutions, and remove artificial barriers to entry. In the banking sector particular attention should be devoted to foster entry in a post-crisis scenario. Competition policy in the financial sector may have also to play an increased advocacy role in the wake of a potential long phase of tighter regulation and public control. This may be important to keep the potential of the financial sector to contribute to financial deepening, innovation and growth.

Competition policy may prove crucial in the way out of the crisis, in the EU to save the single market, and in the international context to avoid protectionist temptations. The experience of 1929 where competition policy was set aside with deleterious economic consequences, as well as the contribution of lack of competition to the Japanese stagnation from the 1990s, should serve as a strong warning.

An open political economy issue is whether to let firms, banks in particular, get so large that have a decisive influence in regulation.

References

- Carletti, E. and X. Vives (2009), “Regulation and Competition Policy in Banking”; in *Competition Policy in Europe. Fifty Years On from the Treaty of Rome*, X. Vives ed., Oxford: Oxford University Press, 260-283.
- Vives, X. (2010), “Competition and Stability in Banking”, in *Monetary Policy under Financial Turbulence, Proceedings of the Annual Conference of the Central Bank of Chile*, forthcoming.