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THE FINANCIAL CRISIS AND THE ROLE OF COMPETITION AUTHORITY IN BANKING SECTOR

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Abstract

Policy intervention in a crisis has to combine the support measures to protect financial stability and the desire to maintain strong competition. In this sense, the competition authority has to watch for distortions on competition. In the first part of the paper, we focus on the EU competition authority that has played an active role during the financial crisis, because it has the unique capability to control state aid and it affects the degree of competition and dynamic incentives through merger policy. Further, we present the mergers of institutions backed by government subsidies or guarantees in Europe Union during the crisis. We concluded that some of member countries have used the merger regulation to fend off foreign entry, because the European legislation allows member states to block a merger to protect financial stability.

In the second part of the paper, we show that the emergency measures taken to remedy the crisis have the potential to harm competition. Although the authorities‘ main concern during the crisis was to restore financial stability, it is now important to fix the potential negative competitive effects of state aid, acquisitions, capital injections and bailouts. Either way, the citizen pays: as taxpayer and/or as consumer through higher prices. In all cases, efficiency and competition are harmed, often with long-term consequences. Therefore, we finally stress that competition policy and enforcement has played an important role in the response to the crisis.

Keywords: competition policy, merger policy, state aid, financial crisis

1. Introduction

The fact that banks are fundamentally different from other businesses may exceptionally justify intervention in this sector. As Vickers J. stated, bank failure risks contagion effects [1]. Linkages between banks through inter-bank markets and payment systems are vital to the functioning of financial markets. The loss of confidence in one major financial institution in a financial crisis can snowball into a loss of confidence in the entire market because the inability of one bank to meet its obligations can drive other, otherwise healthy, banks into insolvency. The risks then become systemic, endangering the whole banking sector. „If the financial sector is not working well, then the entire market economy is not working well. For this reason governments impose significant regulation and

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oversight to ensure the smooth functioning of the financial sector, and, when problems arise, they must act quickly to avert systemic crises" [1]. Government intervention to get banks lending to business on a vigorously competitive commercial basis would enable banks to resume their critical function for the economy as a whole. This would be far better than directing government State aid to failing-firms or their (non) customers. Aside from measures to restore competitive and effective banking, there are two ways in which governments can respond to companies in distress: they can give them money directly via State aid, or grant them monopoly profit by allowing anti-competitive mergers. Either way the citizen pays: as taxpayer and/or as consumer through higher prices. In all cases, efficiency and competition are harmed, often with long-term consequences.

Recent theoretical work suggests that poor competitive conditions in the financial market tend to have a direct negative impact on competitive conditions in downstream industries by restricting firm entry, fostering cartelization and hindering innovation [2-4]. Empirical studies of the relationship between financial and real sector market structure seem to confirm that a concentrated credit market tends to generate higher concentration in downstream industries [5, 6]. The shift in the academic perspective in favour of bank competition and more friendly financial market regulation has accompanied a parallel shift in the way competition policy is organized and implemented. In many countries competition policy was not fully applied or not applied at all until recently in the banking sector. Banking was seen as "a special sector, where business was heavily influenced by the monetary and financial policies of member state authorities, in particular central banks and supervisors, rather than by market forces" (OECD, *Competition and Financial Markets*, 2009, available at http://www.oecd.org/dataoecd/9/22/43067294.pdf).

But, official reports have described the current crisis as a problem of excessive competition in banking. For example, the President's Working Group Financial Market (2008), 'Policy Statement on Financial Market Developments', stresses that the new complex financial instruments, which triggered the crisis, are the results of competition and of the desire to maintain, under competitive markets, high returns. De Larosière Group (2009), 'High level group on financial supervision - De Larosière Group report', emphasizing that exceptionally low interest rates, combined with fierce competition, pushed most market participants to search for higher returns, whether through an increase in leverage or investment in more risky financial products. However this report also stresses the importance to preserve competition throughout the EU internal market.

The crisis has some footing in a lack of proper regulatory oversight by financial sector authorities in various countries in relation to certain key areas. In this sense, we can remind here inadequately regulated housing mortgage distribution markets and related security products, and failure to apply adequate risk management practices. But, there is a broad consensus that the global financial crisis was not a result of a failure of effective competition policy. As such, there is no good reason to exclude competition and market considerations from decisions that will need to be made in this crisis concerning the restructuring of industries and economic sectors going forward. We must stress here the recent statement of the BIAC Competition Committee: „…the challenge for governments is to find the right balance between financial sector regulation directed towards ensuring prudential and fiscal viability on the one hand and applicable norms of competition policy on the other hand, in order for industries and sectors to have the maximum opportunity to grow over the longer term" [BIAC Competition Committee, *The Role of Competition Policy in the Global Financial Crisis*, OECD Strategic Response to the Financial and Economic Crisis, (2009) 6 – 10, available at http://www.worldcommercereview.com/ publications/article_pdf/72].

2. The role of competition policy in banking sector

Competition authorities are accustomed to dealing with many sectors and to applying the law in a way that reflects each of their special characteristics; competition statutes can already be interpreted sufficiently flexibly to take the special traits of the financial sector into account. The adoption of different standards is not required. Competition assessments, whether carried out only by the competition authority or in conjunction with the financial sector regulator, are always essential for mergers, state aid applications and many of the emergency measures that governments might put in place. Views differ, however, as to whether the new regulatory procedures to be introduced would allow meaningful competition assessments to be made in the time available during crises.

Policy goals for the financial sector include promoting both competition and stability. Competition encourages efficient and innovative financial services, while stability is essential to the systemic trust on which the sector depends.

The design of competition policy in banking has also been substantially strengthened at the national level and many exceptions have been removed over the last two decades. For example, in Italy since December 2005 competition policy in banking is no longer enforced by the Bank of Italy but rather by the competition authority as in all other sectors. In the Netherlands, the Competition Act of 1998 applies to the banking sector, but only since 2000, the Minister for Economic Affairs can overturn a merger decision of the competition authority if this conflicts with the one of the supervisory authority. Similarly, in Portugal, the banking system is subject to merger control since 2003, although with a delay of five years relative to the other sectors. Finally a decision of the French Supreme Court in 2003 concerning the merger between Credit Agricole and Credit Lyonnais made it clear that the banking sector was subject to merger control in France. Despite these changes, some important specificity concerning the relationship between competition and stability remains in the institutional design of competition policy in banking. As stated in art. 21(3) of the European merger regulation, "Member States may take appropriate measures to protect legitimate interests other than those taken into consideration by the EC Merger Regulation (…). Public security, plurality of the media and prudential rules shall be regarded as legitimate interests.” [7] Taking it literally, this provision implies that, at least in merger control, stability considerations may override competition concerns.

The financial crisis is expected to generate a significant increase in mergers involving struggling financial firms. Many countries apply a ‘failing firm defence’ for mergers that restrict competition, but where absent the merger the assets of the failing firm would exit the market.

Merger policy in banking should be consistent over time and keep in mind an optimal degree of concentration and dynamic incentives. The proper application of the merger control rules is as necessary as ever. These rules play an important role in ensuring the protection of consumer welfare in terms of lower prices, better products and services and increased innovation. The necessity of maintaining or restoring competitive markets in the medium to long term is not at odds with the need for financial and economic stability in the short term. On the contrary, it forms part of the solution to the problem of market inefficiencies and, as we have seen, market failures. As Xavier V. stated, “how to deal with too-big-to-fail institutions remains an open issue. In the US, too-big-to-fail is not an antitrust issue, whereas in the EU the competition authority controls distortions of competition which arise out of state aid, and this has implications for too-big-to-fail. The credibility of the competition authority to impose conditions once an institution has been helped may provide a commitment device which has been lacking in bank bailouts. Controls on size are problematic, because interconnectedness and line of business specialisation are more relevant to systemic risk than size. In terms of the scope of any bank’s activities, conflict of interest is what leads to potential market failure and should be the focus for any limitations” [8].

A merger that is expected to lead to anti-competitive effects should be prohibited when there is a causal link between the merger and the anticipated harm to competition. When one of the merging firms is ‘failing’ (*i.e.,* it is likely to exit the market absent the merger), however, the future deterioration in competitive conditions does not necessarily result from the transaction and hence the causal link may be missing. The failing firm defence (FFD) is based on the rationale that, because one of the merging parties is failing and its assets would exit the market anyway, the merger is not anti-competitive. A report of OECD (2009) concluded that during economic crises, more firms may find themselves in financial difficulty. Some financially distressed companies will seek to improve their condition by merging with healthier competitors. Competition agencies may therefore face an increasing number of merger reviews involving financially troubled firms, some of which may be true failing firms while others may simply be weak competitors. In some of the cases, parties may put the FFD forward as an argument in favour of approving their transaction. An OECD Report concluded: „there is presently a difference of views between the stated policies of some national European competition agencies and the European Commission. The Commission has moved away from the requirement that absent the merger all the failing firm market share should accrue to the acquirer, but several EU countries have not yet reflected this change in their policies. The low frequency of the FFD and the gradual development of policy through case law may explain the lag." [*The Failing Firm Defence*, Roundtable on Failing Firm Defence, Competition Committee, October 2009, 183-189]

Mergers of large financial institutions are often combined with state funding in one or more ways and may be encouraged by the state. That funding might take the form of loan guarantees, for example. Alternatively, when governments arrange large mergers they may acquire some shares of the merged institution in what could be considered a partial nationalisation. These 'mega mergers' can easily distort competition. They may involve financial institutions with strong balance sheets merging with weaker financial institutions, for instance, which could affect the competitive equilibrium, especially for smaller players who remain in the market. Less overall competition will lead to lower deposit rates and higher loan rates.

3. How competition authorities have supported the European financial sector

The recent financial crisis has put European competition policy to test. Competition law and policy are flexible enough to deal with the financial crisis. European competition policy is accustomed to dealing with many sectors and to applying the law in a way that reflects each of their special characteristics; competition statutes can already be interpreted with sufficient flexibility to take the special traits of the financial sector into account. There is no conceivable reason to relax standards of enforcement: to do so, or to do anything other than maintaining present objectives and standards of competition law enforcement, would jeopardise future national economic performance. Nevertheless, while the principles and objectives of competition law enforcement must not change, the analysis has to be realistic about the conditions in the market. That means continuing the shift from a form-based analysis to a case-by-case analysis in which the context and effects of actual practices and behaviour are very much taken into consideration. Crisis circumstances and the need for emergency decisions require flexibility in procedures and the ability to carry out rapid but diligent assessments of mergers or practices.

The financial crisis has had a hard impact on the economy of the EU. Banks have been deleveraging and have become much more risk-averse than in previous years, leading to a credit squeeze for companies, with a serious downturn affecting the wider economy. In order to overcome the high risk of failure of the largest European banks, many Members States have put stability concerns in front of those related to competition by taking actions to directly intervene in the banking system. The depth of the situation forced also the European Commission to follow the same line. The Commission has recognized the need for flexible procedures in order to safeguard the stability of the European financial systems in times of crisis. DG Competition intervened with an important document on 25th October 2008 concerning 'The application of the State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis', which contained the following requirements:

- non-discriminatory access, i.e. eligibility not based on nationality;
- time-limited state support;
- clear limits on the scale and scope of state support;
- appropriate contributions by the private sector to the costs
- adequate rules to control the behaviour of recipients and prevent abuse of state aid, e.g. to limit aggressive market strategies;
- restructuring either for the financial sector as a whole or for individual institutions.

The various rescue plans for the banking sectors were directly based on state aid, to the extent of forcing the European Commission to adopt, under EC Treaty state aid rules, a Temporary Framework for State Aid enabling Member States to adopt new support measures on a coordinated temporary basis until 2010 (extended through 2011) in order to ensure the restoration of companies' long term viability.

State aid control has proven to be an essential coordination tool to ensure the effectiveness of Member States' rescue packages, and is also bound to have contributed to their sustainability in terms of public finance. The Member States used more than 10% of EU GDP in State aid in order to restore financial stability and normal functioning of financial markets, including EU companies' continued access to credit. The amounts of State aid granted and their strong concentration on a limited number of financial institutions had the potential to create significant distortions of competition. But, available market data suggest that State aid granted in the context of the crisis has not had significant negative effects on the competitive structure of the financial markets overall.

European Commission plays a valuable and important role in keeping state aid to a minimum, to discourage it, and to make sure that, if it has been given, state aid is rolled back as soon as possible. Efforts are thus made to minimize and to avoid as much as possible any market disruptions that may occur due to state aid. The measures that had been taken prohibiting ABN Amro and ING to become price leaders ensure that no unfair advantage is gained as a result of state aid, but it has the drawback of restricting competition in the Netherlands. In order to avoid as much as possible the likelihood of unwanted effects due to behaviour restrictions, the European Commission should actively involve the national competition authorities in state-aid procedures. That way, it is ensured as much as possible that all of the relevant market information is included in the assessment.

Importantly, State aid control has forced the financial sector both to restructure and to share the burden of its rescue with the taxpayers. It ensures that banks must remunerate and eventually repay the aid they receive and take measures to address the distortions of competition associated with the aid. Through burden sharing measures it helps to curtail moral hazard in the future.

The Commission has scrutinised the business models of banks that received large amounts of aid and imposed on them tough measures such as divestments and deleveraging to ensure their long term viability without State aid. This is particularly important for financial stability in the longer term.

The existing merger control rules allow for all the necessary flexibility to deal with sometimes rapidly evolving market conditions. As regards procedure, transactions that require fast treatment, such as those which are part of rescue operations, can be dealt with within a swift timeframe and can where necessary exceptionally be granted a derogation from the stand-still obligation pending a review (in order to enable immediate partial or full implementation of these transactions in urgent cases). On substance, the EU merger control rules allow the Commission to fully take into account rapidly evolving market conditions and, where applicable, the failing firm defence.

The Commission is committed to continue to apply the existing merger control rules, while taking full account of the economic environment. Acquisitions by States of majority stakes in banks are scrutinised under the Merger Regulation where control is acquired and the State does not maintain the acquired entities as independent commercial entities. With one exception involving the take-over of a bank in Germany (Hypo Real Estate) all cases on which the Commission has been consulted in this respect have been provisionally considered not to fall under the Commission's jurisdiction. A recent report of European Commission stated that „There has been relatively little merger activity in the financial services sector as a result of the crisis. Going forward, however, it can be expected that there will be a significant increase in this activity once market conditions have stabilised." [Competition policy and economic recovery, European Commission Competition, January 04 2012, available at http://ec.europa.eu/competition/recovery/financial_ sector.html]

In time of crisis, non-competition objectives such as stability often impact merger clearance decisions. A balance must be struck between short-term gains in stability and the long-term benefits of sustaining competitive markets. Public interest overrides are included in the legislative framework of some jurisdictions, allowing governments to overlook merger rules so that more pressing public interest objectives are served. The use of public interest overrides during the recession was varied. „Some jurisdictions – including the EU, United States China and Japan – chose not override merger rules whilst others – such as the United Kingdom, Italy and Brazil – resorted to public interest exceptions in isolated cases." [9]

4. Consequences of emergency measures on competition and consumers

The global crisis has overridden competition policy concerns. In the EU, up to 30% of GDP has been committed to the banking sector through massive bailouts and state aid. Public help programmes have distorted competition and created an uneven playing field, in terms of the cost of capital and perception of safety and soundness of different entities. Market power concerns about mergers have also been overruled. In the UK, Lloyds TBS took over the troubled HBOS (merger of Halifax and Bank of Scotland) in a merger opposed by the Office of Fair Trade, while in 2001 the same Lloyds TBS had not been allowed to take over Abbey.

The risks with State aid are clear: if the government lacks the expertise and knowledge to sort out efficient from inefficient players, then it may just end up rescuing inefficient firms. A policy that is open to arguments for State aids additionally creates incentives for wasteful rent-seeking activity (businesses seeking profits through manipulation of the economic and/or legal environment rather than trade and wealth production). For these reasons, the EU competition framework uses State aid control to prevent harmful interventions, and independent merger control to prevent mergers that restrict competition. If it is, exceptionally, necessary for the government to intervene (as in the case of banking outlined above), as Fingleton stated [10], state aid might be preferred to allowing an anti-competitive merger:

- State aid may have an immediate effect, whereas monopoly profits may not flow immediately.
- It may be that State aid can be limited in duration (and indeed there may be political mileage in so doing). However, State aid may be extremely difficult to remove because of rent-seeking behaviour by powerful vested interests, as subsidising agriculture in the EU and US demonstrate.
- State aid may be tied to specific policy objectives, such as restructuring, whereas an anti-competitive merger hands a licence to charge monopoly prices with no conditions attached. However, absent clear and measurable incentives, State aid could have the same negative effect on efficiency as anti-competitive mergers.
- On the other hand, State aid that is not applied on an equitable basis can further distort competition by creating an uneven playing field. In contrast, an anti-competitive merger will likely benefit rivals because it lessens competition for all players in the market.

Overall, subsidies harm competition and the consumer and, unless very carefully structured and time-limited, may do as much harm as anticompetitive mergers. The need for intervention to prevent systemic collapse in banking in exceptional circumstances should not cause us to set aside the competitive framework which, in preventing both distortionary State aid and anti-competitive mergers, provides an essential part of the foundation for long-term productivity growth.

Competition policy considerations should play an important role not only in the financial sector bailouts and restructuring but also in the subsequent recovery. In the wake of the financial crisis, governments have been under pressure to support national industries through subsidies and protection. Furthermore, in co-ordination with financial regulators, they have taken emergency and ad hoc measures to shore up financial institutions, in response to severe liquidity shortages and breakdown in lending markets and trusts. These measures have included investments and guarantees, asset purchases and time-sensitive mergers.

Competition authorities may in turn be under pressure to loosen enforcement standards in order to favour economic recovery. In responding to these pressures, competition policy makers must show that competition is part of the solution for benefiting consumers and fostering innovation, competitiveness and productivity. The usual tools of competition analysis and enforcement assume stable market conditions. In a context of crisis, authorities must consider how to safeguard competition principles without hampering policy measures to avoid a slump or the erosion of trust in the financial sector in accordance with Article 107 of the Treaty on the Functioning of the European Union (TFEU) under the Lisbon Treaty.

In the crisis, businesses and small and medium-sized enterprises in particular, are vulnerable due to their heavy independence on bank credit and limited recourse to financial markets. It is thus necessary to assess the differentiated impact on sectors and firms and improve the effectiveness of new, innovative and alternative mechanisms to financial development.

As Lyons B. stated, the problem most familiar to the European debate on State aid is that subsidies create international distortions to competition [11]. Inefficient firms receiving subsidies take market share from more efficient foreign suppliers. This can result in retaliation and a mutually destructive subsidy war funded by taxpayers. However, the problems are not only international. Subsidies undermine the market mechanism because the prospect of a bailout leads to reckless behaviour, as is so vividly illustrated by the banks. There is abundant evidence of the failure of politicians or civil servants to pick winners. More insidiously, there is also a negative effect on efficient firms and entrants who are incentivised to hold back on investment and aggressive marketing because they know that inefficient rivals will hang on to segments of the market with inappropriate product offers and bloated capacity without fear of the consequences.

There is no doubt that restructuring is painful. However, this is less than the harm caused to: efficient rivals who suffer reduced market share; customers who are offered costly and unattractive products; taxpayers whose real income falls; or the elderly, the sick and school children who suffer from diverted public spending. As Lyons declared "it is important that those thrown out of work should receive strong support both financially and in retraining, but it is they who should receive the subsidies and not the shareholders and senior executives of failing firms. It is the latter who benefit most from bailouts." [12]

5. Conclusions

Competition policy and enforcement have played an important role in the response to the crisis. The public policy challenge in response to the development of a financial crisis is to maintain financial stability while preserving incentives for appropriate risk taking and competition in the future.

To protect competition as much as possible, governments should give financial institutions incentives to stop relying on government support once the economy begins to recover. In other words, rescue measures should have conditions built into them that will cause financial institutions to prefer private sources of investment to public ones when economic conditions start returning to normal. For example, governments can make it unattractive for beneficiaries to rely on public capital injections any longer than they have to by imposing restrictions on them such as escalating dividends or interest rates. At some point private sources of equity will become more desirable. The strong desire to prevent future financial crises of similar magnitude means that regulatory intervention and reform should be undertaken. Regulation can be good or bad, however, and can give proper incentives or have the opposite effect. Better regulation of the financial sector might have prevented the crisis, but excessive regulation would risk losing the benefits of competition. Competition authorities must therefore engage in dialogue with those who are going to expand the scope of regulation in order to help frame it and ensure that it is consistent with the aims of a robust competition policy.

Merger activity is expected to increase once financial markets are restored. An increase in merger activity as a result of firms losing market share or solvency, whether because they are inefficient or they are collateral victims, is also likely to result in a higher incidence of failing firm defences put forward. Greater predictability for authorities themselves, for firms and their advisers would be achieved if all competition authorities relied on similar standards for deciding what constitutes a ‘failing firm’.

Despite their imperfections, supranational state aid control rules have proven to be the best available strategy in the EU to deal with the multiple challenges raised by the crisis. Given that they have addressed to a certain extent and *ex post* what *ex ante* adequate regulation should have accomplished, the Commission fully supports the push for regulatory and supervisory reforms that are currently on the table and encourages their swift adoption. The need for a pan-European special resolution regime for banks will be a crucial reform in order to limit and contain moral hazard in the banking sector.

The crisis only enhances the need for diligent and vigilant competition policy. Rather than fall into the fallacy of sacrificing competition supposedly to avoid the short-term consequences of recession, there is a need to enforce it robustly to avoid negative long-term consequences. The anticompetitive features of government interventions are not always noticed in the heat of a crisis. Such features may or may not be intentional, but they are often long-lived.

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