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

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The past

- Banking was one of the most regulated sectors in the economy
- Competition was thought to be detrimental to stability for a long time
- In many countries competition policy was not applied fully to the sector till recently, despite:
  - Weight of the banking sector in the economy
  - Crucial role to provide finance to firms and liquidity
  - Some forms of cooperation being necessary (e.g. payment systems)

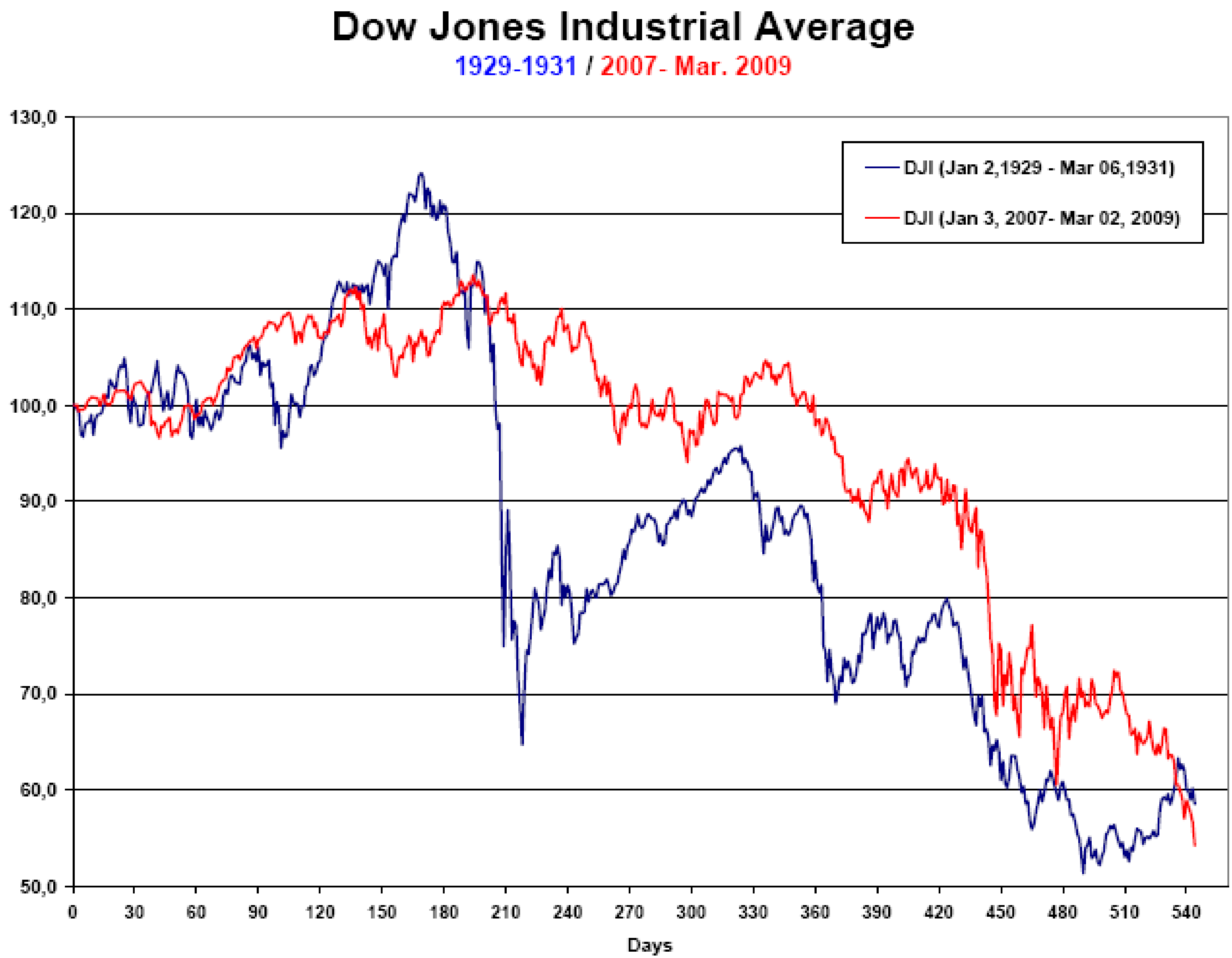
Competition policy in banking in the EU

- Until relatively recently central banks and regulators
  - were complacent with collusion agreements among banks;
  - preferred to deal with concentrated sector
- Competition policy is now taken seriously in the banking sector
  - The Commission has intervened in all areas:
    - against national protectionism, mergers, price agreements, abuse of dominance, state aid (Carletti and Vives (2008))
- Competition policy has been substantially strengthened at the national level over last two decades
  - Even though in some countries it presents special features for banking
    - Italy till 2005, Netherlands till 2000, Portugal till 2003, France 2003

The shock

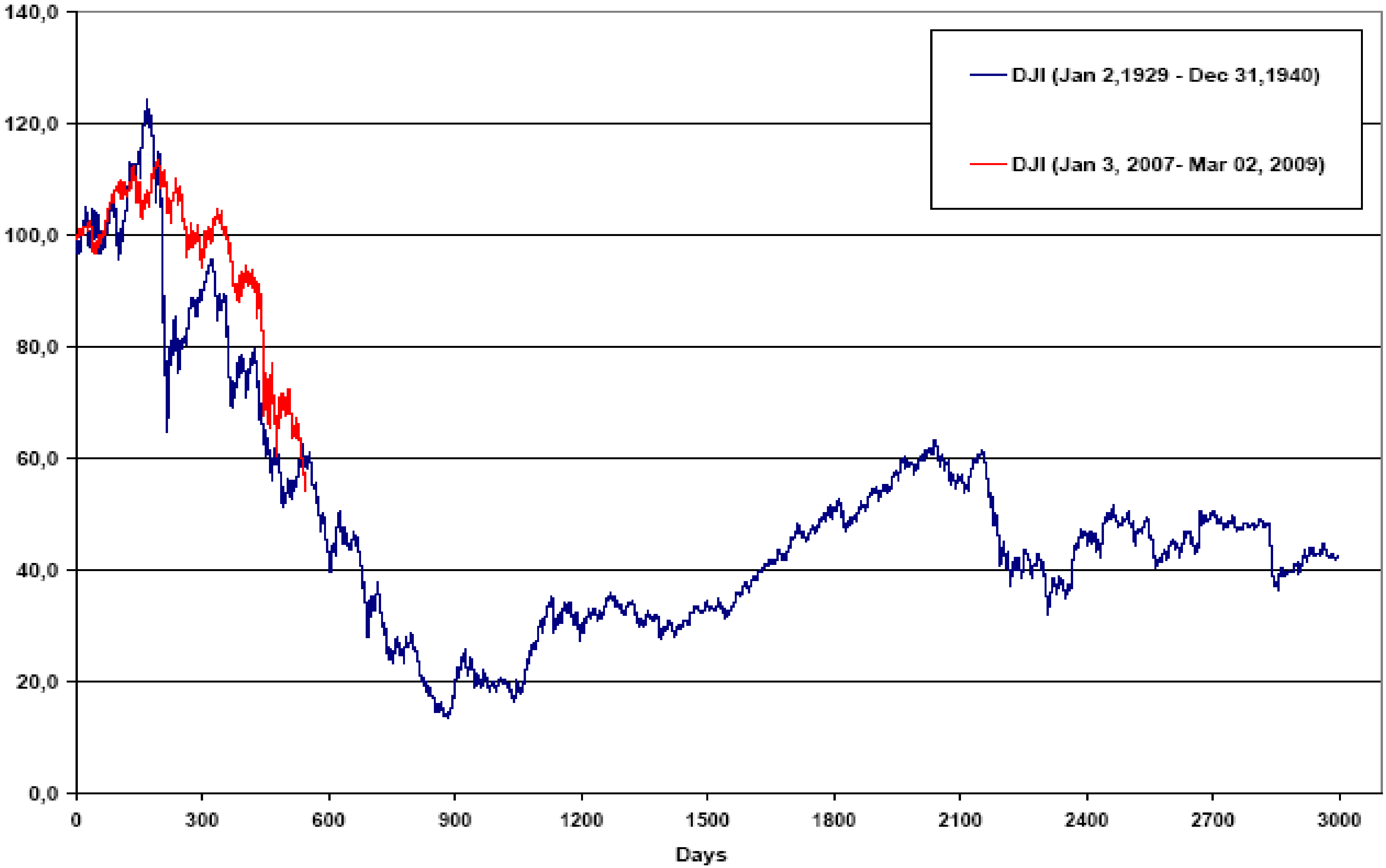
FEAR INDEX


90
80
70
60
50
40
30
20
10
0
Jan-07
Mar-07
May-07
Jun-07
Aug-07
Oct-07
Dec-07
Feb-08
Apr-08
Jun-08
Aug-08
Oct-08
Dec-08
Feb-09

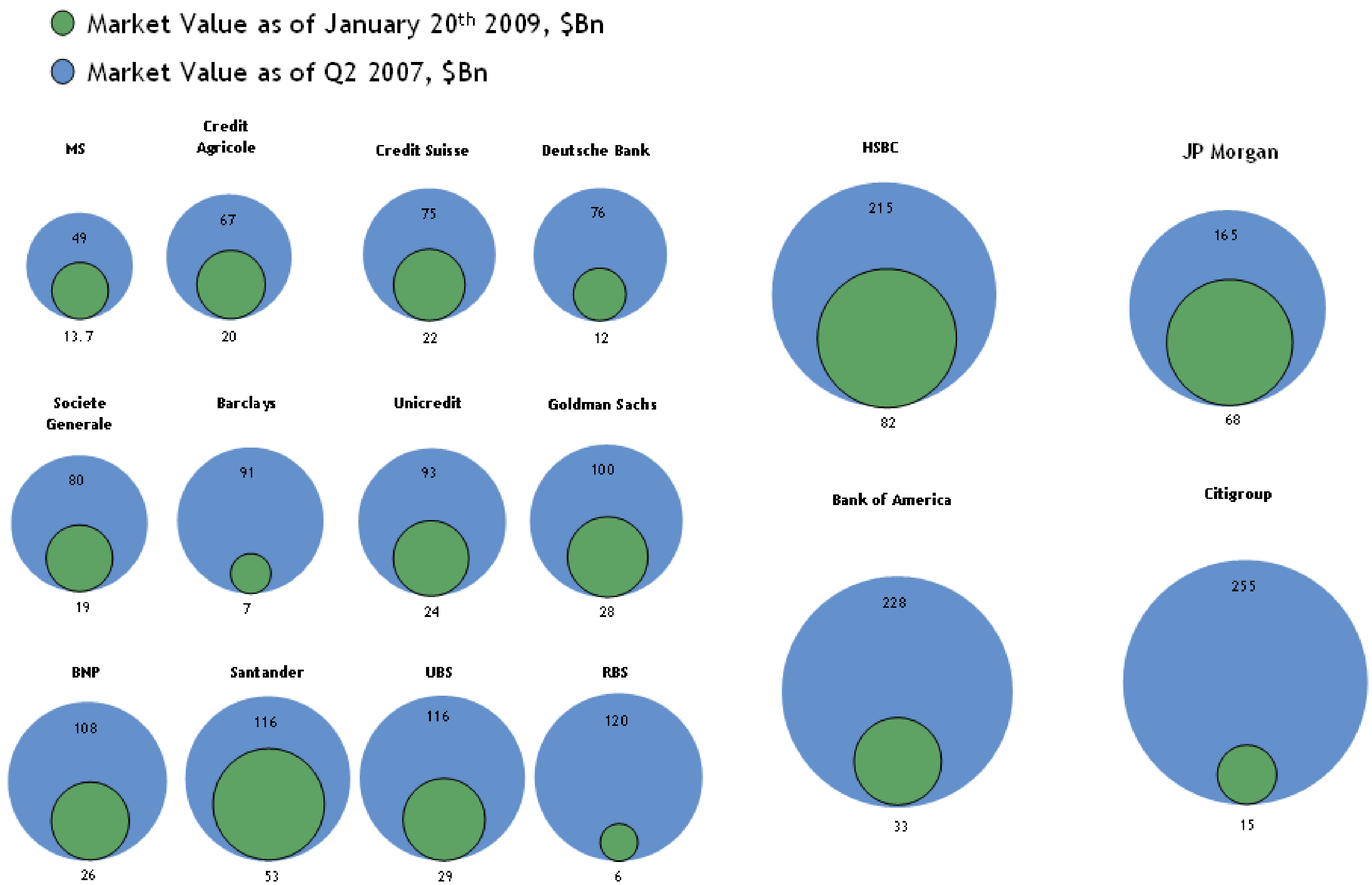

Dow Jones Industrial Average
1929-1931 / 2007- Mar. 2009
DJI (Jan 2,1929 - Mar 06,1931)
DJI (Jan 3, 2007- Mar 02, 2009)
130,0
120,0
110,0
100,0
90,0
80,0
70,0
60,0
50,0
0
30
60
90
120
150
180
210
240
270
300
330
360
390
420
450
480
510
540
Days

Dow Jones Industrial Average

1929-1940 / 2007- Mar. 2009



What the banks are worth



J.P.Morgan

While JPMorgan considers this information to be reliable, we cannot guarantee its accuracy or completeness

Source: Bloomberg, Jan 21th 2009

Consequences of the shock

- Systemic crisis (post LB failure) overrides competition policy concerns
- Crisis arises out of macro policy and regulatory failure mostly, not because of competition issues
- Massive bailout (state aid) and distortion of competition:
  - Cost of capital
  - Quality (safety, vertical differentiation)
- Market power concerns on mergers overruled
  - HBOs-Lloyds TBS, …; Abbey-Lloyds was blocked ….
- It is naive to think that banking is like any other sector in regard to competition policy: Why?

What do banks do?

- Provide transaction services/payment system
- Provide insurance and risk sharing (maturity transformation)
- Finance illiquid entrepreneurial projects
- The essence of banking: liquidity provision and fragility
  - Banks create liquidity and this leaves them vulnerable to runs
    - Banks protect entrepreneurs from the liquidity needs of depositors/investors.

The uniqueness of banks

- Banks are unique (mix of features):
  - High (short term) leverage,
  - Dispersed debtholders (less monitoring)
  - Opacity and long maturity of bank assets exacerbate moral hazard problem
  - Fragility with high social cost of failure
  - Subject to *contagion* (via interbank commitments or indirect market-based balance sheet linkage) with *systemic* impact
- Banks have central position in economic system:
  - They are essential: when banks stop functioning a modern monetary economy stops

The role of fragility and crises

- Make payment to depositors contingent on returns and may improve risk sharing
- Help control incentives of banker
- Some crises are optimal
- Threat of liquidation disciplines banks managers but typically there is excessive liquidation/fragility

Regulation

- Rationale:
  - Systemic risk and economy-wide externalities
  - Protection of investor
- Facilities and policies:
  - Lender of Last Resort, Deposit Insurance
  - "Too Big to Fail"
  - Capital requirements, prudential regulation
  - Supervision
- Side effects/distortions

Competition in banking

- From tight regulation to liberalization:
  - Competition enhances efficiency
    - Productive, allocative, dynamic (innovation)
- But there is no convergence to perfect competition in liberalized environment. Frictions remain:
  - Asymmetric information
    - Competition may not deliver efficient outcomes:
      - » Loan market (adverse selection)
      - » Credit rating agencies: Issuer-pays model and conflicts of interest, entry restrictions, failure of reputation mechanism and race to the bottom?
  - Switching costs,
  - Network effects (retail banking, credit cards, markets)
  - Two-sided competition

Competition and stability

- Two channels through which competition may increase instability:
  - By exacerbating coordination problem of depositors/investors on the liability side and fostering runs/panics
  - By increasing incentives to take risk on the asset side and raise failure probabilities

Competition and fragility

- Runs can happen independently of level of competition but stronger competition worsens coordination problem of investors/depositors by increasing:
  - Potential instability (multiplicity of equilibria region)
  - Probability of crisis
  - Range of fundamentals for which there is coordination failure of investors (and institution is solvent but illiquid)
  - Impact of bad news on fundamentals

Excessive risk taking

- Banks will have excessive incentives to take risk in the presence of limited liability (for shareholders and managers) and moral hazard (non-observable risk on asset side).
- This is exacerbated by flat deposit insurance.
- Problem particularly acute for banks close to insolvency/bankruptcy
- Intense competition may worsen excessive risk taking problem (high profits provide buffer and increase “charter value”)
- Tougher competition may lead to more risky portfolio’s of banks and higher failure probabilities
  - A larger number of banks may increase chance that bad borrowers get credit by reducing the screening ability of each bank due to adverse selection/winner’s curse problem
  - But better terms for firms may induce entrepreneurs to exert more effort by increasing the return on their investment

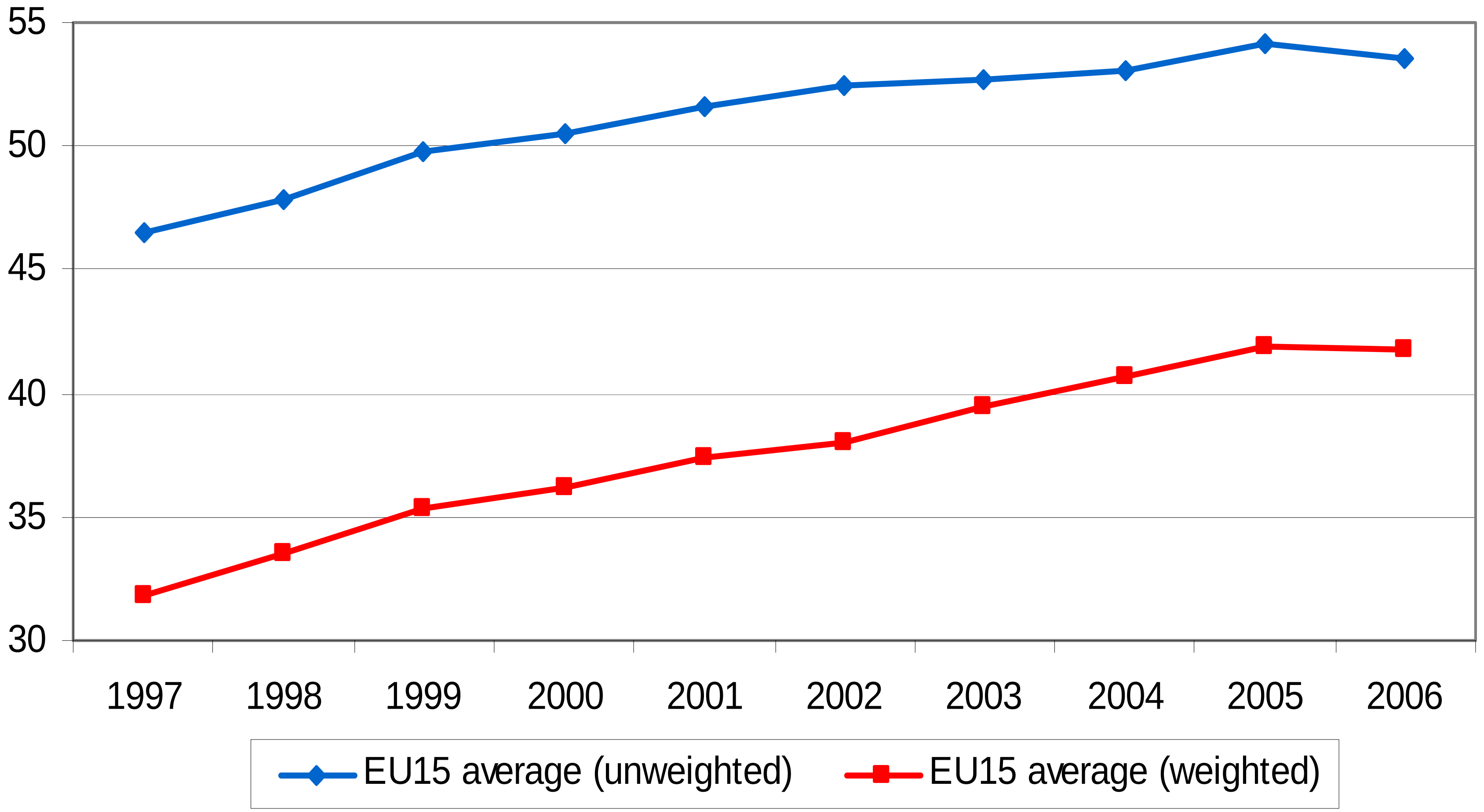
Concentration and stability

- Concentrated banking system with a few large banks:
  - May be easier to monitor
  - Banks are better diversified
- But large banks are:
  - TBTF, and receive larger subsidies and have incentive to take more risk
  - More complex and harder to monitor

Evidence is mixed

- Increased competition after liberalization/deregulation in the US in 1980s leads to
  - Increased risk taking by banks
    - in particular by large banks TBTF
  - Lower or higher loan losses?
- Cross-country (69 countries, 1980-1997):
  - Systemic crises less likely in concentrated banking systems
    - (controlling for macro, financial, regulatory, institutional and cultural characteristics)
  - Fewer regulatory restrictions (on entry, activities, facility for competition) associated with less fragility
  - “More competitive banking systems are associated with less fragility when controlling for concentration”
- Large banks need not be better diversified (except if more spread geographically)
- Institutions close to insolvency have incentives to gamble for resurrection
  - e.g. S&Ls crisis

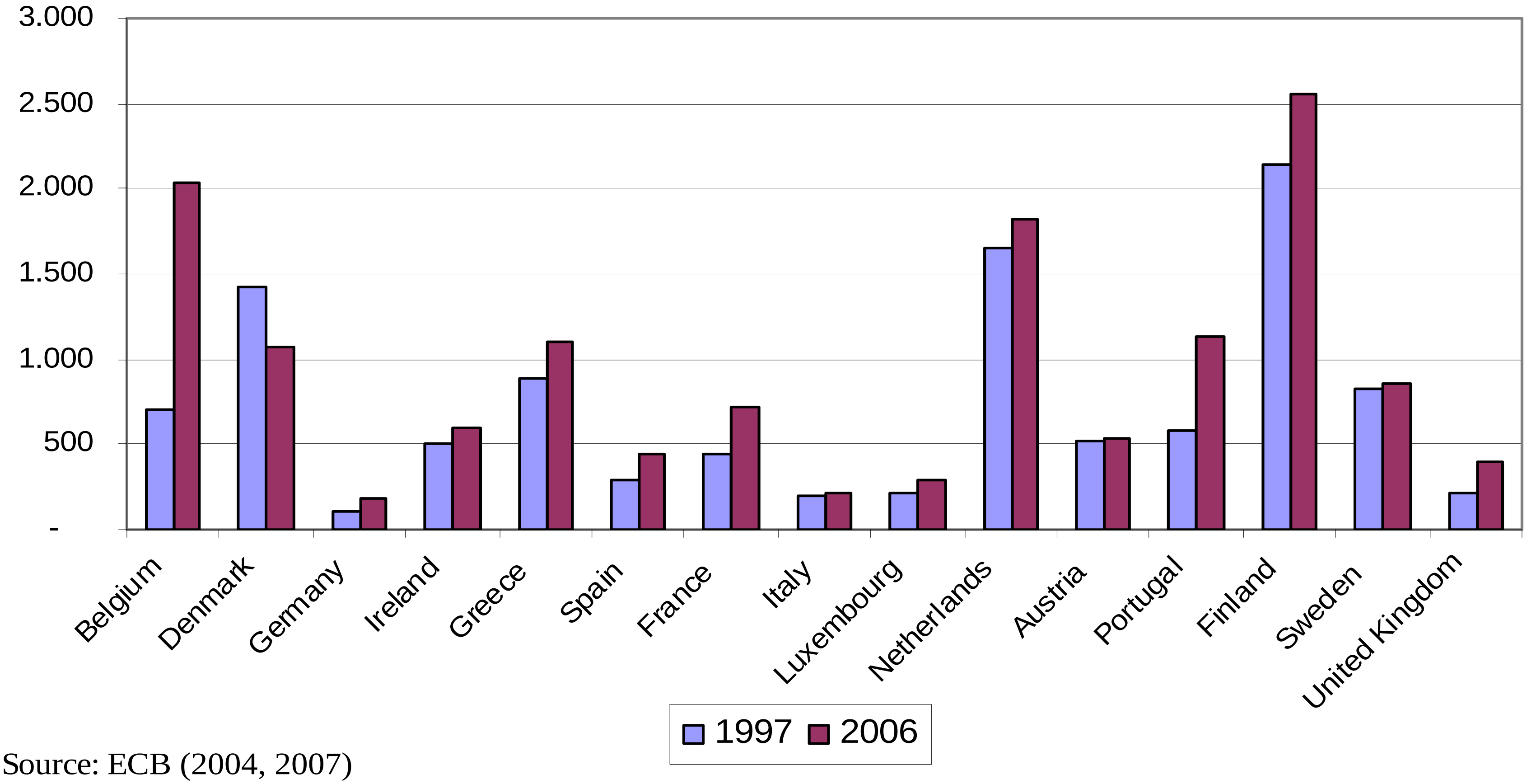
Share of CR5 in % of total assets



Source: ECB (2006, 2007)

Figure 2.

Herfindahl index (total assets; index from 0 to 10,000)



Source: ECB (2004, 2007)

Competition and regulation

- Increase in competition beyond some threshold will increase risk taking and failure probabilities
- This tendency is enhanced by flat-premium deposit insurance/TBTF policies and opacity of risk position of bank
- Regulation
  - Risk-sensitive insurance moderates risk taking incentives on liability side (but still excessive risk in the presence of social cost of failure)
  - Disclosure alleviates risk taking on asset side
  - May need to complement capital requirements/rate regulation with asset restrictions
- Three pillars of Basel II:
  - Capital requirements
  - Supervision
  - Market discipline

Vives (World Bank Research Observer, 2006)

	Risk taking incentives		Regulation
Banking regimes	**Liability (Rates)**	**Asset (Investment)**	**(With low charter value & high social failure cost)**
Free banking (observable risk/ high disclosure)	medium-low	absent	Capital requirements
Free banking (unobservable risk/ low disclosure)	medium-high	maximal	Capital requirements + Asset restrictions
Risk-insensitive insurance	high	maximal	
Risk-based insurance	low	absent	Capital requirements

Tentative conclusions

- Trade-off between competition and stability is complex but seems real (along some dimensions)
- Some degree of market power in banking is good:
  - Because of stability concerns
  - To check risk taking
- Optimal degree of concentration is probably intermediate
- Competition should be limited for troubled institutions

Competition policy in a crisis (I)

- Competition policy geared towards avoiding anticompetitive effects in individual crisis/failures
- What to do in a systemic crisis?
  - Tremendous pressure to stabilize the system
    - Asset purchases, guarantee schemes (deposit insurance, interbank market, mutual funds),
    - Capital injections, nationalization
    - Mergers
  - Tremendous distortionary potential
    - Moral hazard
    - Uneven playing field
    - Long term effects in market structure
    - Threat to single market, subsidy races/national champions
    - Spillovers to other sectors

Competition policy in a crisis (II)

- Aim must be to preserve the long term viability and strength of competition in the financial sector
  - Merger policy should be perhaps more lenient in banking but consistent over time (with an optimal degree of concentration in mind)
- In the short term:
  - Liquidity support has to be facilitated
  - Restructuring decisions have to be made quickly
  - Competition has to be restricted/regulated for entities
    - close to insolvency (E.g. S&Ls)
    - and those which have received subsidies and/or TBTF
- Need collaboration of competition authority and regulator to enforce/monitor temporary behavioral commitments

State aid

- Two reference cases
  - Credit Lyonnais in France (cost up to 2.5% of GDP)
  - State guarantees in Germany for Landesbanken and saving banks (to comply with capital requirements)
- Now EU is dealing with many banking aid cases (up to Dec. 2008)
  - 22 decisions in 2008:
    - Mostly approved/without objection (some arguments in Germany and France)
      - guarantee schemes (DK, FI, PT, IRL, NL, SWE, FR, IT)
      - asset purchase schemes (ES)
      - holistic schemes with all of the above (DE, UK, GR)
      - individual recapitalization or guarantees cases
  - 2 cases currently under formal investigation procedure
  - 15 cases under assessment

State aid

- Threat to EU state aid rules:
  - EU reacts quickly
- Conditions for state guarantees/recapitalization (Communications Oct.-Dec. 2008):
  - Non-discriminatory access:
    - Level playing fields among institutions and banking sectors
  - Help limited in time and scope (only necessary liabilities)
  - With contribution of private sector and with appropriate market-oriented remuneration for support or recapitalization
  - Behavioral rules for beneficiaries:
    - Commitment to expand or to limit lending?
  - Incentive for State capital to get out eventually
  - Distinction between sound and distressed banks
    - Recapitalization only for fundamentally sound institutions
    - Restructuring for the others

How to approach state aid in banking?

- Competition, stability and regulation are directly linked
  - Systemic institutions may need help
  - But bailouts create perverse incentives:
    - They remove market discipline and induce excessive risk taking (TBTF)
- State ownership is distortionary:
  - Government is on both sides of the regulatory relationship
  - Political objectives/incentives rule
  - Soft budget constraint and inefficiency
  - Eliminates market for corporate control
  - Uneven playing field (implicit guarantees)
  - Less competition and lower financial development
- But the Treaty is blind to the form of ownership
  - Fiction of legal separation (State keeps public entitties as “economic units of independent power of decision”)
- How to prevent that the present distortions become permanent and spill over to other sectors?

Mergers

- US:
  - Safe haven merger thresholds somewhat more lenient in banking
  - “Competitive review” by regulator (keeps final authority) and DOJ
    - Regulators more lenient than DOJ
    - If “probable failure” regulator may act immediately
- EU
  - Art. 21(3) of EMR: “Member states may take appropriate measures to protect legitimate interests…prudential rules shall be regarded as legitimate interests”

Competition policy and failed banks

- Merger policy affects degree of competition and dynamic incentives
- Merger of failed bank rewards incumbent with temporary monopoly rents, induces monopoly inefficiency but prudent behavior
- This is optimal if subsequent entry is facilitated.

Crisis examples

- US: forced subsidized/guaranteed mergers of Bear Sterns with JP Morgan and of Merril Lynch with Bank of America
- UK: HBOs-Lloyds TBS approved against OFT's opinion (with partial nationalization) despite:
  - 30% market share in current accounts/mortgages
  - SME banking services in Scotland
  - (Lloyds not allowed to take over Abbey in 2001)
- Questions:
  - Failing firm defense not applicable because of public intervention?
  - Better to recapitalize/nationalize and keep independent?
  - Factors to consider:
    - Degree of concentration/charter values in UK before merger
    - Dynamic incentives for prudence of incumbents
    - Ease of entry

The tension in the EU/euro area

- One money, one market and many regulators
  - Prudential control and stability in national hands
- Mergers:
  - Art. 21(3) of EMR: "Member states may take appropriate measures to protect legitimate interests…prudential rules shall be regarded as legitimate interests"
  - Misused in Portugal, Italy, …
  - Should individual Member States implement this exception?
- National champions:
  - UK rescue package: saving the world or saving the City?
  - Spanish banks from ex ante strong to ex post medium capitalization

Conclusions (I)

- Banking is no longer an exception in the enforcement of competition policy (CP)
  - This is how it should be to guarantee competitive financial input
- Competition is not responsible for fragility, but CP should recognize explicitly uniqueness of banks (and not only in crisis situation):
  - Extra allowance for market power/concentration?
  - Consider effects of regulation/safety net/TBTF
  - Delineate liquidity help from subsidy and set up emergency procedure on liquidity and restructuring issues
  - Reward prudence (dynamic incentives)
  - Restrict activities of institutions which are close to insolvency

Conclusions (II)

- Role of competition policy
  - To keep markets open, foster integration, weed out inefficient institutions, and remove artificial barriers
  - To check the distortions introduced by rescue packages
  - Crucial to get out of the crisis and save single market (1929)
  - Increased advocacy role in a new long phase of tighter regulation and public control?
    - Financial deepening-innovation and growth

Two recommendations

- Prudential/stability matters with cross border impact should not stay in national hands in the euro zone
  - Two models:
    - ECB with supervisory powers over cross-border groups
    - European FSA
  - Coordinated restructuring when there is solvency problem with European DIF
- Banking sector specificity in competition policy should be recognized and exception limited.
  - This would protect competition policy in banking.
  - Help avoiding the extension of bailouts to other sectors.

Some background references

http://webprofesores.iese.edu/xvives/

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