Discussion Points

Presented by the Competition Committee of the

Business and Industry Advisory Committee (BIAC)

to the

OECD Competition Committee Roundtable on

Competition, Concentration and Stability in the Banking Sector

February 17, 2010

Introduction

1. The Competition Committee of the Business and Industry Advisory Committee (BIAC) to the OECD appreciates the opportunity to submit these comments on competition, concentration and stability in the banking sector to the OECD Competition Committee.

2. The financial services sector is at the heart of every well functioning market economy. Certainly, the events leading up to, during and following the recent financial crisis have highlighted this point well. If there is any breakdown or failure in this sector, its effects, as recently witnessed, are felt across national borders and throughout market economies. While the failure of other industries or sectors may be painful, the same concerns regarding a potential collapse of the global financial system do not exist. In this regard, the financial services sector is unique and stands separate and apart from other industries as a cornerstone of the global market economy.

3. With this in mind, it is important to consider the interrelationship among competition, concentration and stability in the banking sector.¹ This paper provides BIAC’s views on this issue generally, and focuses in particular on the role competition policy should play given the interconnection among competition, concentration and stability in the financial services sector. The paper also briefly discusses whether the crisis in the financial sector was caused by failure of adequate prudential regulation in the financial sector, or whether there

¹ BIAC recognizes that the banking sector is made up of many different types of services and activities (e.g., consumer lending, retail banking, investment banking) which have unique features requiring particular regulatory focus.
were also failures of competition policy that may have contributed to the crisis in the financial sector, although this latter point was discussed in BIAC’s submission to the OECD’s 2009 Competition Committee Roundtable on Competition and the Financial Crisis in February of 2009.

Background – Competition, Concentration and Stability

4. There is a longstanding debate both in academic literature and in the policy arena on the relationship between competition, concentration and stability in the banking sector.

5. On the one hand, there are academics and policy makers who believe that more competition in banking results in greater instability and more market failures, other things being equal. This theory suggests that banks operating in a concentrated market (or in a market that restricts entry) will earn profits that can serve as a buffer against fragility, and as an incentive against excessive risk taking. More competition, which puts more pressure on profits, is thought to create higher incentives for banks to take greater (potentially excessive) risks, resulting in greater instability. This theory predicts that deregulation, resulting in more entry and competition, would ultimately lead to more fragility. It also holds that a more concentrated banking system might reduce the supervisory burden of regulators, thus enhancing overall stability.

6. The opposing view is that a more concentrated banking structure in fact results in more bank fragility. Such an environment is believed to enhance fragility by, for instance, allowing banks to boost the interest rates they charge to firms which may induce firms to assume greater risk, resulting in a higher probability of non-performing loans. A higher concentration of larger firms is also thought to increase contagion risk. In concentrated markets, it is presumed that banks will tend to receive larger subsidies via “too-big to fail” policies, thereby intensifying risk-taking incentives and increasing banking system fragility. This perspective counters the argument of less need for supervision in a highly concentrated market with the idea that concentrated banking systems tend to have larger banks, which offer an array of services, making them more complicated to monitor.

7. Studies and empirical research results testing each of the above theories have shown mixed results. BIAC appreciates that these schools of thought will have an impact on how the banking sector is regulated, and how competition policy may need to be adapted or tailored with respect to the banking sector.


4 Ibid.

5 Ibid.

6 Supra, note 2.
Competition Policy and the Banking Sector

8. In general, in the absence of the risk of market failures, open and competitive markets are expected to function efficiently, with little need for regulation. However, there are situations where a market or sector has certain unique characteristics that make intervention through regulation prudent. The banking sector (in fact the whole financial services sector) is a prime example of one such sector; it is, therefore one of the most regulated sectors of the economy.

9. Banks are regarded as unique and deserving of special treatment for several reasons. First, they are fundamentally crucial to a well-functioning economy. The ability of a firm to obtain credit is often crucial to its ability to invest and is consequently a necessary ingredient for growth and innovation. Accordingly, problems in the financial sector inevitably affect the performance of other markets for goods and services and the economy as a whole. And as the recent financial crisis demonstrated, a crisis that arises in one country can quickly move to another. Banks have a central position in the economic system. Once they stop functioning, the modern monetary economy stops working. And there is a high social cost associated with their failure.

10. Thus, any competition policies that are set, either in response to the financial crisis, or in response to policy initiatives that attempt to address the impact of competition, concentration and stability in the financial services sector, must take into consideration the effect that such policies could have on the broader economy, not only in the home jurisdiction where regulation is imposed, but in other countries around the world. Policies should be closely coordinated, not only within regulatory agencies in each country, but also globally.

11. Banks also have unique characteristics which make them more vulnerable to instability than firms in other sectors. Instability can arise because of a variety of factors. For example, banks are vulnerable to runs or panics. The great majority of their liabilities are liquid deposits, redeemable upon demand, whereas their assets are illiquid loans. Thus, if all depositors tried to withdraw their deposits at the same time, a bank would face serious problems in meeting its obligations to its depositors.

12. Banks are also susceptible to instability because they are subject to inter-bank contagion. Banks can be linked through inter-bank commitments or indirect market-based balance sheets. Thus, the failure of a bank can lead to the decline in the value of the assets in another bank, sufficient to induce its failure. It can also cause the failure of a completely solvent bank through a flight of funds (i.e., as depositors, unable to determine the solvency of any banks, indiscriminately rush to withdraw their funds).

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8 The recent financial crisis has shown that, even though a sector may be highly regulated, it is still susceptible to potential instability; in other words, the focus should be on regulation that is well reasoned and sensible, rather than too much or too little.
11 Ibid.
12 Supra, notes 7 and 9.
13. Instability can also arise from excessive risk taking, especially where, in this sector, the risk of failure of financed investment is mostly carried by depositors, while profits which arise from successful investments accrue to banks. This problem is exacerbated by two important features of the banking system: (i) it is easy for banks to cover any misallocation of resources (at least in the short term) because bank assets are opaque, with a long maturity; and (ii) bank debt is spread among several depositors/debt holders, who may be small and uniformed, thereby making effective monitoring and discipline on banks difficult. As summarized in a recent article, “because banks can behave less prudently without being easily detected or paying additional funding costs, they have stronger incentives to take risk than firms in other industries.” Moreover, incentives to take greater risks increase where a bank is in financial trouble (e.g., institutions close to insolvency have “incentives to gamble for resurrection”).

14. Excessive risk taking by banks was identified as one of the causes of the recent global financial crisis. In recent remarks made by U.S. President Barack Obama on the financial crisis and financial reforms, he stated:

This economic crisis began, when banks and financial institutions took huge, reckless risks in pursuit of quick profits and massive bonuses. When the dust settled, and this binge of irresponsibility was over, several of the world’s oldest and largest financial institutions had collapsed, or were on the verge of doing so. Markets plummeted, credit dried up, and jobs were vanishing by the hundreds of thousands each month. We were on the precipice of a second Great Depression.

15. For all of these reasons, regulation of the banking sector is viewed as essential. Indeed, since the writings of Adam Smith, market experts and analysts have recognized that the profit incentive particularly in certain sectors such as financial markets needs to be subject to proper and effective oversight by government authorities. Two principal questions that arise are: what is the appropriate level of this ‘proper and effective oversight’? For example, should regulation limit the size of banks (and reduce concentration)? Should regulation limit the activities that banks can engage in (e.g., separating commercial banking from investment banking)? And second, what role does competition policy play? The first question is beyond the scope of this paper. Rather, as noted, the paper focuses on the appropriate role of competition policy.

16. In order to assess the proper role of competition policy, it is necessary to first ask whether competition policy was a contributing factor to the financial crisis. As discussed in BIAC’s submission to the OECD’s 2009 Competition Committee Roundtable on Competition

13  Supra, note 7.
16  Supra, note 9.
and the Financial Crisis, the financial crisis was not caused by a lapse in competition policy. Commentators have suggested that the recent financial crisis had some footing in a lack of proper regulatory oversight by financial sector authorities in various countries in relation to certain key areas. As a result of the financial crisis, governments around the world have tried to address such concerns by taking measures to increase and improve regulatory oversight and also by implementing changes to current policy. While lapses in prudential regulation may have played a role in the financial crisis, the failure of competition policy or adequate competition law enforcement was not a contributing factor to the crisis in the financial sector. However, as discussed in BIAC's submission, competition policy, suitably applied, can have an important role to play in the recovery.

The Role of Competition Policy and Banking Sector Stability

17. Presently, the banking sector is subject to scrutiny by competition/antitrust regulators across many jurisdictions. Firms in the financial services sector are not exempt from the application of laws which regulate mergers and unilateral conduct and which prohibit cartels.

18. For example, the European Union has frequently applied competition laws to various cases involving financial institutions, including mergers (e.g., such as the BSCH/A. Champalimaud case relating to a merger involving Portuguese banks), cartels (e.g., where fines were imposed on German banks and Austrian banks for price fixing), and abuses of dominance (e.g., such as the Clearstream Banking AG case where the company, and its parent company, were found to have infringed competition rules for applying discriminatory prices and for refusing to supply cross border securities clearing and settlement services).

19. For example, the European Union’s (“EU”) Council of Finance Ministers agreed, on June 9, 2009, to a new structure of supervision in the EU, essentially consisting of four new entities, including the creation of the European System of Financial Supervisors, which will be composed of three authorities that will have supervisory responsibilities (such as the participation in supervisory colleges of international groups and the control of national supervisory authorities) and extensive regulatory tasks (such as the realisation of a single rulebook and the consistent application of EU law). One of the three authorities is the European Banking Authority.


21. Ibid.

22. See BSCH/A. Champalimaud, Case No. IV.M.1616.


Additionally, financial institutions in the EU have also faced scrutiny from national competition regulators in the member states.

19. In other jurisdictions, competition laws have special provisions or exemptions that are applicable to firms in the banking sector. For example, the United States has special rules which apply to the review of bank mergers. Unlike most other industries, bank mergers in the United States are generally exempt from the merger review process under the Hart-Scott-Rodino Act of 1976. The federal banking agency considers likely competitive effects, along with financial soundness and other banking-specific concerns. The U.S. Department of Justice provides its competitive analysis to the banking agency, and, in practice, the banking agency usually works closely with DOJ and defers on competition concerns.25

20. In Canada, mergers are analyzed by the Commissioner of Competition (the head of Canada’s Competition Bureau) under special Merger Enforcement Guidelines that have been developed with respect to banking mergers and she will advise the Minister of Finance of her conclusions regarding the competitive effects of a proposed merger. However, it is the Minister of Finance who is given the authority, under Canadian legislation, to approve mergers in the financial sector. Canada’s Competition Act also has a special criminal provision dealing with agreements between federally regulated financial institutions and special foreign ownership restrictions apply to the financial sector.

21. As discussed above, the banking sector has certain unique characteristics that make it susceptible to market failures. Hence, as a starting point, competition policy alone is likely not enough to ensure that the financial system will continue to function with an adequate measure of stability – virtually every jurisdiction will have some form of prudential regulation over the banking sector. And as recent history has shown, where such prudential regulation is lax or lacking, systemic problems can ensue with significant consequences.

22. This does not mean that competition policy does not have a role in maintaining stability for the banking sector. On the contrary, competition policy can serve to keep markets open, foster integration, weed out inefficient institutions, and remove artificial barriers, all of which can contribute to the stability of the banking sector.26 (Indeed, for those types of banking activities where consumers are more directly affected, the role of competition law and policy may be particularly important.) Competition policy can also help to keep in check distortions that may be introduced by rescue packages and can play a crucial role in the recovery period following a crisis.27

23. Moreover, from BIAC’s perspective, healthy competition per se is not detrimental for banking system stability in a market-based financial system. For example, the incentive for banks to develop innovative products does not necessarily imply less stability, provided that the necessary supporting prudential safeguards are in place to backstop excessively risky behaviour. In other words, there is an important interaction between the regulatory and supervisory framework, on the one hand, and market structure and competitiveness, on the other hand, in achieving banking system stability.

24. While unchecked competition may lead to fragility in a weak institutional environment, from an institutional framework perspective, it is important to focus on improving the

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26 Supra, note 9.

27 Ibid.
mechanisms for prudential supervision, rather than placing limits on competition. Otherwise, the benefits that competition provides, generally and to the banking sector in particular, may be diminished (e.g., lower prices or fees and interest rates, better services for retail customers, choice and availability of affordable financing).

25. From BIAC’s perspective, there is no clear evidence that businesses have suffered from the manner in which competition law and policy has been applied to the banking sector over the past decade.

26. That being said, some commentators have suggested that the application of competition policy as applied to the banking sector may need to be modified in certain respects to recognize the uniqueness of the banking sector. For example, perhaps competition should be limited for troubled institutions (such as those that are close to insolvency or those that are “too big to fail”) and activities of at risk institutions should be restricted. Where behavioural commitments are negotiated, collaboration between the competition authority and the regulator may be needed to enforce/monitor these commitments.

27. In addition, there has been much focus on the types of financial services banks and other financial institutions should be permitted to engage in, the extent to which such institutions should engage in a variety of activities, as well as the optimal size of financial institutions.

28. As a general principle, in our view, concentration should not be restricted by rules applicable to the banking sector in terms of a specific size or separation of activities. For example, a system that relies on a large number of smaller and less diversified banks (which are more likely to depend on the capital market for their borrowing requirements) may not be more stable than a system that relies on larger, more geographically and sectorally diversified institutions. Moreover, BIAC is concerned that a crude separation of commercial banking and investment banking activities intended to constrain excessive risk-taking with customer deposits may be counterproductive. Commercial and investment banking activities are not by definition irreconcilable and in our view do not in and of themselves require separation into wholly unconnected entities. Indeed, the OECD itself has suggested that these two types of activities be separated within banks through the use of internal holding structures, without the need for a complete divestment. In this way, with appropriate oversight, risks associated with both activities may be adequately contained.

29. Principles of competition law and policy focusing on the promotion of fair and effective competition through open, transparent and non-discriminatory markets should continue to apply to the banking sector. Deviation from such normative principles should occur only after careful consideration, in light of other important policy objectives and based on sound empirical evidence that such modifications will produce the desired policy outcome.

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28 Ibid.
29 Ibid.
30 One of the proposed reforms to the financial system that President Barack Obama announced on January 21, 2010 related to the separation of certain financial activities. Termed the “Volcker Rule”, banks would no longer be allowed to own, invest or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers. See January 21, 2010 remarks by U.S. President Barack Obama (source: www.whitehouse.gov/the-press-office/remarks-president-financial-reform).
of greater stability for the financial system while continuing to capture the benefits that arise from effective and vigorous competition within the financial services sector.

**Conclusion**

30. In sum, competition policy does play an important role in the stability of the financial sector by maintaining fairness through open markets and providing the necessary incentives for firms to maintain lower prices, allow for enhanced choices for individual and business customers, and produce innovative financial service products. These benefits do not have to be sacrificed for the sake of banking stability, provided competition policy is suitably applied in the context of an appropriate, non-discriminatory and balanced regulatory environment. In this connection, it is clear that competition policy enforcement needs to work in tandem with, rather than in place of, prudential regulatory safeguards in the banking sector.