CPI's Europe Column Presents:

Competition and Stability in Banking in the EU

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Competition in banking has been perceived with suspicion, and even suppressed for extended periods. Competition policy in the banking sector has evolved through different phases. After the Great Depression in the 1930s and up to 1970s, when the liberalization process started in the United States, competition was suppressed in banking, and competition policy was not enforced despite the inefficiencies induced by financial repression. In this period, central banks and regulators in a range of countries tolerated collusion agreements among banks and preferred to deal with a concentrated sector characterized by annulled rivalry. This changed when the idea that competition enhances efficiency took hold in the financial sector and liberalization and deregulation ensued.

In the EU, the European Commission (EC) did not apply the two main competition articles of the Rome Treaty (85 and 86) to banking until the early 1980s. There was also a process of removal of banking exceptions to competition policy at the national level in the EU. Up to the 2007–2009 crisis and in advanced economies such as the EU, competition policy in banking was getting closer to being implemented as it would be in any other sector of economic activity, but still with some special provisions. This normalization of competition policy in its treatment of banking and finance was truncated by the deep financial crisis that began with the crisis in 2007–2009 and that overrode concerns about competition policy. The state aid programs created an uneven playing field in terms of the cost of capital for entities deemed too-big-to-fail (TBTF) and mergers were allowed without concern for market power. An example is the merger of HBOS and Lloyds in 2009 in the UK, which was approved against the opinion of the Office of Fair Trading (OFT). This is despite the fact that the "failed-firm defense" doctrine cannot be applied to large banks since the assets of those distressed banking firms typically do not leave the market because of financial-stability concerns. Supervisors favor mergers to save banks in trouble, while competition authorities are more reluctant but either acquiesce or are overruled. Stability concerns clashed with fostering competition. This is so because the merged entities consolidate an anticompetitive market structure. At the same time, those banks are more likely to be Too-Big-To-Fail (TBTF) and may contribute to future instability.

The crisis of 2007–2009 and its aftermath constituted a shock to competition policy practice, which either had to accept being superseded by financial stability considerations, or adapt quickly trying to control the competitive distortions introduced by the massive help to the banking sector. The EC, in contrast to the US Department of Justice, has authority over state aid control and has shown its commitment to deal with the competitive distortions of the aid to the banking sector that the financial crisis brought.

The aftermath of the crisis has posed a host of new questions on the relationship between competition and financial stability, as well as between competition policy and regulation in banking. This is discussed in my recent book *Competition and Stability in Banking* *(Princeton University Press, 2016)*. The thesis of the monograph is that competition is unequivocally socially beneficial, provided that regulation is adequate, but that in practice a trade-off between competition and financial stability arises due to regulatory imperfections. Regulation and competition policy can be viewed as complementary or substitutable policy tools, and there is a need of coordination between them. For example, competition policy is a good tool to attack the TBTF problem in the EU by controlling the competitive distortions that TBTF entities generate when they get into trouble and are helped. In this sense competition policy can be seen as complementary to prudential policies. A different case is when the prudential authority imposes deposit rate limits to entities that exploit deposit insurance to attract funds (as it has been the case in Spain and Portugal). This measure restricts competition directly and although it could be substituted in theory by an appropriate risk-weighted deposit insurance premium, in practice this becomes very difficult to implement. Another example is when in booms banks have incentives to over-lend and consumers to over-borrow (the latter perhaps out of behavioral biases). Then prudential rules that limit the amount of a mortgage loan that can be given as a percentage of the value of the house or consumer protection rules restricting the choice that intermediaries can offer consumers, limit competition among banks but at the same time that they avoid credit oversupply and the buildup of risk in the real estate sector.

The coordination of competition and regulatory policies and authorities does not mean that policies should be enforced by the same agency. Agencies for competition policy and prudential oversight should be separate and with respective missions, competition and stability. This separation of agencies avoids the potential conflict of interest of competition policy and supervision, provides well-defined missions and accountability for both agencies, promotes information generation, and limits capture possibilities. The institutional arrangements for consumer protection are diverse in different countries but in continental Europe they usually involve the prudential supervisor (sometimes with shared responsibility with other regulators). This is not an appropriate arrangement. Consumer protection should be separated from the supervisor in charge of stability, since sometimes the objectives may conflict. Furthermore, both competition policy and consumer protection have consumer welfare as their objective, and therefore they should be under a common roof. The new UK regulatory architecture attains a reasonable compromise in regard to the trade-offs of integration versus separation of regulators. The Prudential Regulatory Authority (PRA), subordinate to the Bank of England, is responsible for micro-prudential regulation, with a secondary competition objective; and the Financial Conduct Authority (FCA) is responsible for conduct regulation with a competition and consumer protection remit.

The financial regulatory architecture in the eurozone is more complex because of its federal character and recently has moved to a strong centralized prudential supervisor, the ECB, also in charge of systemic stability, keeping the EC as an independent competition authority. Furthermore, cross-border resolution of entities in trouble needs ex ante burden-sharing and coordination of agencies or a federal structure, as the miscoordination occurred in the case of the rescue of Fortis during the crisis shows. However, the interaction between the resolution agency in the eurozone, the newly established Single Resolution Board, and the competition agency in charge of state aid control, the EC, is delicate and will need a memorandum of understanding to ensure smooth collaboration. Finally, the supervisors inside and outside the eurozone have a coordination system, but there is no unified financial conduct authority, like the FCA in the UK. This may end up representing an obstacle to deepening market integration as projected in the capital markets union.

In short, competition policy has to be part of the solution to the banking instability problem. In order for this to happen, prudential and competition policies must be coordinated.

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