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COMPETITION AND FINANCIAL MARKETS

-- Note by BIAC --

This note is submitted by BIAC to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 16 - 18 February 2009.

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COMPETITION AND FINANCIAL MARKETS

-- Contribution by BIAC --

1. Introduction

1. The Competition Committee of the Business and Industry Advisory Committee (BIAC) to the OECD appreciates the opportunity to submit these comments to the OECD Competition Committee on the relationship between financial sector conditions and competition policy.

2. The OECD Secretary-General has recognized that the “world is currently facing the most severe financial and economic crisis in decades” and has further acknowledged that “competition policy considerations should play an important role...in the subsequent recovery.”¹ This paper provides BIAC's views concerning the appropriate role of competition policy in relation to the current global financial crisis, focusing on the following issues:

- Was the crisis in the financial sector essentially caused by failure of adequate prudential regulation in the financial sector, or were there also failures of competition policy that may have contributed to the crisis in the financial sector?
- How can competition policy reduce the negative impact of the financial crisis on the wider economy and bring about a return to economic growth?

2. Causes of the Financial Crisis

3. In assessing the appropriate role of competition policy in relation to the financial crisis, it is essential to look at the primary causes of the crisis recognizing that there may be varying opinions as to the weighting of the various contributory factors.

4. In this paper, BIAC does not attempt to provide a definitive analysis of what caused the financial crisis. Undoubtedly, there is much room for debate on that score and the final chapters of the saga are yet to be written. One thing, however, is clear: whatever the causes, it was not a failure of competition policy or adequate competition law enforcement that led to the crisis in the financial sector. This paper provides BIAC's perspective on the appropriate role of competition policy and the likely challenges that competition authorities will face during the difficult economic times which lie ahead.

5. Some commentators have suggested that 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 such as housing mortgage distribution markets, inadequate corporate governance and failure to apply adequate risk

¹ C(2008) 191/FINAL at pages 3 and 7 (para. 13).

management practices. These analysts point to what they believe was a lack of appropriate risk management regulations,² and an excess of global liquidity as two of the primary contributing factors.³

6. In any event, a series of developments appear to have contributed to the crisis:

- granting of mortgages by financial institutions to homeowners without proper assessment of credit worthiness, equity, or pursuant to a prudent ratio;
- allowing mortgage insurance companies to operate without providing for adequate reserves and oversight; and
- allowing various financial institutions and organizations to create inadequately supported and essentially unregulated security products (e.g., such as collateralized debt obligations and credit default swaps) and then sell them to various international financial institutions, all over a period of relatively low interest charges and easy financing.⁴

7. These developments allowed contamination from toxic assets to spread across the globe. Subsequently, a number of prominent financial institutions turned to their respective governments for support resulting in significant government involvement in certain large financial institutions.

8. What followed was a drop in investor confidence, causing a decline in global stock markets and the devaluation of virtually all traded securities, and a decrease in available capital and liquidity as many affected institutions began to call in loans that otherwise would have made funds available to various operating businesses and industries, which created the credit crunch that began the domino effect across industries on a global basis.

² In addition to regulatory oversight failure, they also point to perceived failures within many private sector financial institutions to apply their internal risk management and best practices procedures.

³ See E. Andrews, Greenspan Concedes Error on Regulation, *The New York Times*, October 23, 2008 (source: <http://www.nytimes.com/2008/10/24/business/economy/24panel.html>). See also A. Faiola, E. Nakashima and J. Drew, What Went Wrong?, *The Washington Post*, October 15, 2008 (source: <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/14/AR2008101403343.html>); T. Donohue (President and CEO, U.S. Chamber of Commerce), Reforming Financial Regulations, *uschamber.com magazine*, December 2, 2008 (source: <http://www.uschambermagazine.com/content/081202.htm>).

In a January 13, 2009 speech, Ben S. Bernanke, Chairman of the Federal Reserve, stated

“High on the list, in light of recent events, are strengthening regulatory oversight and improving the capacity of both the private sector and regulators to detect and manage risk.”

(source: <http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm>).

See also D. Gerard, Managing the Financial Crisis in Europe: Why Competition Law is Part of the Solution, Not of the Problem, *Global Competition Policy*, December 2008 (source: www.globalcompetitionpolicy.org).

⁴ Id. See also article by Alan S. Blinder, (Professor of Economics and Public Affairs, Princeton University) Six Errors on the Path to the Financial Crisis, *The New York Times*, January 25, 2009 (“In 1998, when Brooksley E. Born, then chairwoman of the Commodity Futures Trading Commission, sought to extend its regulatory reach into the derivatives world, top officials of the Treasury Department, the Federal Reserve and the Securities and Exchange Commission squelched the idea.”). (<http://www.nytimes.com/2009/01/25/business/economy/25view.html?scp=1&sq=blinder%20and%20princeton&st=cse>)

9. Nobel prize winning economist, Joseph Stiglitz explained that even Adam Smith, who is often regarded as a staunch proponent of free markets, recognized that some regulation is necessary:

“Adam Smith, the father of modern economics, is often cited as arguing for the ‘invisible hand’ and free markets: firms, in the pursuit of profits, are led, as if by an invisible hand, to do what is best for the world. But unlike his followers, Adam Smith was aware of some of the limitations of free markets, and research since then has further clarified why free markets, by themselves, often do not lead to what is best. ...

Government plays an important role in banking and securities regulation, and a host of other areas: some regulation is required to make markets work....

The real debate today is about finding the right balance between the market and government... Both are needed.”⁵

10. Indeed, in his Inaugural Address, President Obama stated:

“Nor is the question before us whether the market is a force for good or ill. Its power to generate wealth and expand freedom is unmatched, but the crisis has reminded us that without a watchful eye, the market can spin out of control ...”⁶

11. Some commentators have pointed to the loosely regulated environment for the granting of mortgages and subsequent packaging of mortgages into investment products as a principal cause of the financial crisis.⁷ While they have suggested that ordinary "greed" is at the heart of the crisis, BIAC does not agree with that notion. 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.

12. While it appears to have started in some sectors in the United States, the financial crisis has had a profound impact around the world, given the prominence and importance of the US financial system. Ironically the global market for mortgage-backed securities may have been enhanced by the flight from equities resulting from earlier periods of market volatility and the desire to spread the investment risk across a range of real assets, which would naturally include property related assets in the US and around the globe.

13. Thus, the current financial crisis has illustrated two important realities concerning the nature of the global economy, both of which help explain why the crisis has had such wide reaching effects.

⁵ Daniel Altman, *Managing Globalization*. In: *Q & Answers* with Joseph E. Stiglitz, Columbia University and *The International Herald Tribune*, Oct 11, 2006. See also paper by the International Chamber of Commerce entitled “ICC key messages on the financial crisis”, wherein it stated that the “ICC has always emphasized that a market economy system can only work well within a framework of rules.”

⁶ See Text of Inaugural address by President Barack Obama (Jan. 20, 2009) available at <http://www.whitehouse.gov/blog/inaugural-address/>.

⁷ J. Becker, S. Stolberg and S. Labaton, White House Philosophy Stoked Mortgage Bonfire, *The New York Times*, December 20, 2008 (source: <http://www.nytimes.com/2008/12/21/business/21admin.html?scp=1&sq=increase%20home%20ownership&st=cse>). See also L. William Seidman: “To make the market work well, you have to have a lot of rules.” as quoted in Becker, Stolberg and Labaton.

14. First, the financial services sector which gave rise to these problems is at the heart of every well functioning market economy. Regardless of the industry, the ability to obtain credit is often crucial to a firm's 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.

15. A major consequence of the crisis in the financial services sector is that other industries have been forced to face crises as well. Because of the global financial crisis, these issues are now receiving more urgent attention and industry is likely to look very different post-financial crisis.

16. Second, the US economy continues to be the most open and interdependent economy in the world. It possesses the world's largest GDP and largest consumer market of any nation⁸ and, in this respect, continues to command an influential role notwithstanding the steady rise of other developed and developing regions. As a consequence, when the U.S. economy sneezes, many other countries catch a cold.

3. Issues concerning the Role of Competition Policy in the Current Financial Sector Conditions

17. Governments and financial regulators are taking emergency measures in response to severe liquidity shortages and breakdowns in lending markets. A prime example of this is the US \$700 billion bailout package announced by the United States in the fall of 2008,⁹ which followed the failure of several financial institutions.

18. Competition authorities are hard-pressed to participate in emergency measures to shore up financial institutions, mainly for two reasons. First, the usual tools of competition analysis and enforcement presuppose relatively stable market conditions and these do not exist during a time of financial crisis. Second, mergers have traditionally been the preferred method for absorbing and "rescuing" a troubled institution.

19. However, with the outbreak of the financial crisis, governments have been providing more direct support by acquiring equity stakes in troubled companies, buying troubled assets or providing guarantees. These types of commercial arrangements may also have competition policy effects, particularly in the international context (e.g., issues concerning maintaining a level playing field internationally).

20. Competition authorities must consider how to safeguard competition principles in emergency settings without hampering policy measures that may be necessary to avoid the costs of a liquidity slump and erosion of trust in the financial sector.¹⁰ This raises a number of questions concerning the appropriate role of competition policy in an economic crisis, such as:

- Should competition law be set aside in the financial sector during a systemic crisis, on public interest or other grounds?

⁸ The US has the largest GDP in terms of any single country; the EU, taken as a whole, has a slightly larger GDP than the US. See <http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/index.aspx>.

⁹ Credit Crisis – Bailout Plan, *The New York Times* (source: http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit_crisis/bailout_plan/index.html?scp=2&sq=%22%24700%20billion%20bailout%22&st=cse).

¹⁰ C(2008) 191/FINAL at para. 14.

- How should competition agencies apply and adapt general competition policy rules about mergers and anticompetitive conduct during an economic crisis?

21. BIAC does not suggest or support radical changes to competition policy in these circumstances. It is well-established that the system of open market based economies is more effective in creating consumer welfare, more efficiencies and overall wealth for societies than any other system. Excessive economic controls by central governments have proved largely to be less efficient and less wealth maximizing. Accordingly, in formulating policy measures to address the economic crisis, governments should strive at all times, and to the extent realistically possible, to have normative competition principles form part of the decision-making process. Debates about lessons to be learned from the financial crisis must not be about the "end of capitalism" or the "failure of the market economy."

22. Rather than see the pendulum swinging to excessive regulation and intrusion on an overly draconian basis, there should be a careful and well-thought out balancing of the role and principles applicable to crisis management on the one hand and the maintenance of normative competition/free market principles on the other.

23. Policy debate about the appropriate scope of regulation needs to be based on facts and not be driven by ideology or opportunism. Specifically,

- Protectionism should be prevented; markets should be kept open and transparent but subject to appropriate regulatory supervision.
- No matter how tempting it may be to protect and promote "national champions", increased state intervention in the economy should be treated with care.¹¹ The role of state aid and public procurement policy is important, in addition to regulation.
- A certain degree of risk-taking is necessary in order to promote and foster innovation.
- Empirical evidence and analysis should guide the policy action and the implementation of solutions.
- The process of deregulation and increased reliance on competition policy should continue in relation to markets that are presently excessively regulated especially in newly industrialized nations.

24. Even if there were a desire to put constraints on competition policy enforcement during a time of crisis, it would be very difficult to implement such constraints given, among other things, the global nature of the financial sector and the need to define the criteria for the "official crisis period".

25. In short, competition policy cannot be ignored or temporarily set aside; rather it must be utilized as a tool within the overall economic and financial policy framework to achieve effective but not excessive regulation.¹² Competition policy also can act as a stabilizing force and provide legal certainty in uncertain economic times.¹³

¹¹ For further discussion regarding this issue, see BIAC's companion paper entitled "*Competition Policy, Industrial Policy and National Champions*."

¹² See The Enforcer: Can Neelie Kroes, Europe's competition chief, stand up to governments as well as companies?, *The Economist*, January 10th, 2009, p.59, which suggests that the temporary effective

4. Challenges for Competition Policy

26. Even though the current financial crisis was not caused by a failure of competition policy, BIAC members believe that competition policy, suitably applied, has an important role to play in the recovery.

27. First, competition policy can work in tandem with sector specific regulation, especially in relation to the financial services sector.

- As discussed, the financial services sector is at the heart of every well functioning market economy. The maintenance of economic stability is a function that only governments both individually and collectively can effectively perform and is one that cannot be abdicated. If there is any break down or failure, its effects, as recently witnessed, are felt across national borders and throughout market economies. While the failure of other industries may be painful, and may affect numerous stakeholders, the same concerns regarding the potential collapse of the global financial system would not exist. In this regard, the financial services industry is unique and stands separate and apart from all other industries as the keystone of the global market economy.
- Financial regulators should apply their expertise in regulating standards of prudence while competition authorities should apply normative competition provisions in the review of business conduct and significant acquisitions. In this respect, it is important for competition policy makers to show “that competition is part of the solution for benefiting consumers and fostering innovation, competitiveness and productivity”, as brought out by the OECD Secretary-General.¹⁴
- In sum, unnecessary and duplicative regulatory oversight can be avoided while ensuring there is effective coordination across relevant government agencies when it comes to regulatory oversight over financial services. The role of competition policy will continue to be an important component of this process.

28. Second, competition law enforcement agencies will require the tools and mechanisms that are necessary to operate with sufficient flexibility to complete even large and complicated reviews (particularly in the area of mergers) in an expeditious timeframe where the circumstances warrant.

- The need for effective and expeditious antitrust review mechanisms is an important objective even under normal economic circumstances. However, in a time of a global financial crisis, there may be circumstances that narrow the window of opportunity for a particular measure (e.g., a

suspension of competition law during the Great Depression led to anticompetitive behaviour, which economists consider to have prolonged the economic downturn.

¹³ See D. Gerard, Managing the Financial Crisis in Europe: Why Competition Law is Part of the Solution, Not of the Problem, *Global Competition Policy*, December 2008 (source: www.globalcompetitionpolicy.org).

¹⁴ C(2008) 191/FINAL at para. 14. See also paper by John Fingleton, CEO, UK Office of Fair Trading, entitled “Competition Policy in Troubled Times”, January 20, 2009 (source: http://www.offt.gov.uk/shared_offt/speeches/2009/spe0109.pdf) where he states, *inter alia*:

"The credit-crunch raises a more general risk that the emphasis on open, competitive markets and the benefits that they deliver is reduced or even lost as part of an over-regulatory response. The suspension of competition rules by the Roosevelt administration in 1933 is argued to have added to the duration of the Great Depression, and government intervention to restrict competition in 'structurally depressed industries' prolonged the Japanese recession in the 1990s. On top of the clear evidence that competition contributes positively to productivity growth and competitiveness, these episodes should serve as a warning against the attractive sirens of reduced competition."

merger) to have the maximum benefit for the overall economy. Accordingly, it is important that competition law enforcement authorities have the flexibility to perform their duties in an expeditious and practical manner.¹⁵

- In this respect, early, timely and open disclosure and continuing dialogue with parties affected by a competition law review and potential enforcement action is critical. This includes not only the private sector but other relevant government agencies with parallel jurisdictions.
- Procedural flexibility should not, however, open the door for uncertainty in substantive results through attempts to incorporate vague and quasi-political public interest standards. For economic growth through business investment, there needs to be relative certainty as to how framework laws such as competition law will operate including likely substantive results. Unnecessary uncertainty can drive away investment, economic growth and the attainment of efficiency. However, this does not preclude some sensible adaptation and extension of existing policies to adjust to current economic conditions in order to respond quickly and pragmatically to changing priorities. Examples might include greater application of the “failing company” defence and greater attention being given to efficiency arguments.

29. Third, effective coordination and cooperation among domestic competition law enforcement agencies will be all the more important since a review by any single agency may prevent or delay a multinational transaction in times when timing may be of the essence.

- This is an area where the OECD Competition Committee could play a leading and constructive role in the future. The OECD Competition Committee has a history of developing Recommendations and Best Practices in areas such as: exchange of information between competition authorities, merger reviews and anticompetitive practices affecting international trade.
- It is conceivable that Recommendations and Best Practices (or another form of cooperation such as suggested guidelines) could be developed in areas where there is a need to work in parallel with other government interests, such as where competition law enforcement interfaces with distressed economic circumstances affecting entire market sectors. In this regard, the OECD Competition Committee could draw upon principles which are used in a number of jurisdictions, as a possible area of convergence.¹⁶

¹⁵ For example, Neelie Kroes, the European Commissioner of Competition, has stated:

“The College of Commissioners has granted new powers to ensure that rapid decisions are made to protect our future...Using these powers, I am able to decide favourably on emergency rescue measures of financial institutions within a very short timeframe, including over the weekend, to protect our future.”

See *Competition policy and the financial/banking crisis: taking action* (source: http://ec.europa.eu/commission_barroso/kroes/financial_crisis_en.html) (as displayed Jan. 20, 2009). See also the article The Enforcer: Can Neelie Kroes, Europe’s competition chief, stand up to governments as well as companies?, *The Economist*, January 10th, 2009, p.59, which highlights the importance of flexibility in these circumstances.

¹⁶ For example, several jurisdictions, such as the European Union, the U.S. and Canada, have a “failing firm” doctrine whereby antitrust authorities will take into consideration whether a firm is failing (e.g., by examining the firm's financial statements, projected cash flows, indebtedness) in determining the competitive effects of a merger. See Part VIII of the EU’s Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, Official Journal C 31, 05.02.2004, p. 5-18 (source: <http://eur->

- Consideration should be given to the development of guidelines or Best Practices (whether in conjunction with an OECD discussion or by nations themselves) which would set out the process and principles governing the review of major market restructuring in times of financial crisis.¹⁷ This will allow for considerable thought to be given in establishing the appropriate framework in advance of critical decision-making time periods and thereby incorporate normative competition principles. There are immediate benefits to both public and private sector interests in having such decisions made in as timely a manner as possible, thereby avoiding unnecessary uncertainty. By allowing representatives of respective government departments (e.g., competition authorities, financial regulators and any other relevant authorities) to confer as early as possible and share relevant information, greater efficiency should be achieved and the risk of conflicting decisions should be ameliorated, thereby reducing uncertainty and delay.¹⁸ Fundamental to this notion, however, is the importance of protecting competitively sensitive confidential information; procedures must be in place to allow for voluntary waivers and assurances that information exchanged will not be treated with any less confidentiality protection than would otherwise apply under the relevant existing statutory criteria for either agency.¹⁹
- BIAC would be pleased to offer assistance and input to the OECD Competition Committee in these efforts going forward.

30. In this context, BIAC has not lost sight of issues concerning state aid in relation to the financial crisis. This topic gives rise to a number of particular and sensitive questions, for example, that there likely will be a need to balance the need for flexibility against the risks of straying too far from normative competition policy principles in creating long-term adverse effects on the marketplace. Therefore, BIAC suggests that state aid be part of the overall discussion at the OECD, as the OECD Competition Committee is well placed to provide guidance concerning key normative concepts in this area. Once again, BIAC would be pleased to offer assistance and input going forward.

5. Conclusion

31. In conclusion, the current global financial crisis was not caused by a failure of competition policy but, rather, a failure of adequate prudential regulation in the financial services sector. Nevertheless, competition policy has an important role to play in the recovery. It cannot be set aside or temporarily suspended. On the contrary, the benefits to the economy and consumer welfare that sound competition policy produces (namely, innovative products, greater choice and transparency and economic efficiency)

lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:031:0005:0018:EN:PDF). See section 5.0 of the U.S. 1992 Horizontal Merger Guidelines (source: <http://www.usdoj.gov/atr/public/guidelines/hmg.htm#5>). See also subsection 93(b) of Canada's *Competition Act* and part 9 of the *Merger Enforcement Guidelines* regarding failing firms

(source:[http://www.competitionbureau.gc.ca/eic/site/cbbc.nsf/vwapj/2004%20MEGs.Final.pdf/\\$file/2004%20MEGs.Final.pdf](http://www.competitionbureau.gc.ca/eic/site/cbbc.nsf/vwapj/2004%20MEGs.Final.pdf/$file/2004%20MEGs.Final.pdf)).

¹⁷ For example, in Canada, the Canadian Competition Bureau has published Merger Enforcement Guidelines as Applied to a Bank Merger (Draft). Among other things, these guidelines set out the framework for both the substantive principles that may be applied and the review procedure and coordination process to be followed in significant bank mergers by the Competition Bureau and the Ministry of Finance.

¹⁸ Experience has shown that in parallel merger reviews or conduct investigations among different regulatory authorities, the best way to avoid conflicts, which can produce uncertainty and delay, is to have teams on the ground working together from the beginning of the process.

¹⁹ Recognition of this issue and the establishment of applicable protocols have been instrumental to effective coordination in the context of cross-border merger reviews.

need to be harnessed. In addition, competition law and policy needs to be applied in a coherent and coordinated manner in conjunction with regulatory oversight of the financial services sector.

32. BIAC agrees with the OECD Secretary General that the "task ahead is to build a sound governance and regulatory framework that will align incentives, while maintaining a healthy balance between markets on the one hand, and policy interventions on the other."²⁰

²⁰ C(2008) 191/FINAL at para. 4.