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Competition Policy and Sector-Specific Regulation in the Financial Sector - Note by Martin Hellwig

Roundtable on Co-operation between Competition Agencies and Regulators in the Financial Sector

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Competition Policy and Sector-Specific Regulation in the Financial Sector

Note by Martin Hellwig*

1. Introduction

1. In a decision of February 2005, the German Federal Cartel Office ruled that Deutsche Post AG, the incumbent monopolist in the postal sector, was infringing European antitrust law.1 Specifically, Deutsche Post’s refusal to allow the provision of consolidation services (collection and pre-sorting of mail) by competing companies was judged to be an anticompetitive abuse under Article 82 of the Treaty (now Art. 102 TFEU).2 Unlike the Federal Cartel Office, the Regulatory Authority for Telecommunications and the Postal Sector3 had previously refused to accept the complaints of aspiring providers of consolidation services.

2. The case illustrates the potential for conflict that is present when a given industry is subject to both, competition law and sector-specific regulation.4 The different decisions of the two authorities were based on different legal norms. The Regulatory Authority based its decision on the German Postal Services Law, according to which consolidation services remained in the reserved domain of the incumbent monopolist. The Federal Cartel Office based its decision on the Treaty’s prohibition of anticompetitive practices in combination with the Postal Services Directive, which had mandated an immediate opening of markets for mail consolidation services.5 The legal norms were in conflict because the German legislator had chosen to violate the Directive. A ruling from the European Commission that the law and administrative practice were incompatible with Articles 86 and 82 of the Treaty was contested by the German government, which calculated that proceedings in the European Court of Justice would take a long time, providing Deutsche Post with protection from competition in consolidation services for a few more years. The Federal Cartel Office’s decision upset that calculation.

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3 Now part of the Federal Network Agency.


Unclassified
3. The direct applicability and the precedence of EU competition law over national sector-specific law also played an important role in the Deutsche Telekom and Telefonica cases, in which the European Commission held that Deutsche Telekom and Telefonica engaged in anticompetitive abuses because the prices that they charged to competitors for network access and to customers for services implied margin squeezes that made it impossible for other firms to compete in service provision without losing money. The prices in question had actually been approved by the national telecommunications regulators, so one might have thought that the Commission should have brought proceedings against Germany and Spain for Treaty infringements by their regulators. However, the Commission held that, even the prices in question had been approved by regulatory authorities, under a regime of price cap regulation, the telecommunications companies had some leeway of their own to fix prices and were therefore directly responsible for the margin squeezes. In both cases, this view was upheld by the European Court of Justice.

4. The examples illustrate the conflicts that can arise when an industry is subject to both sector-specific regulation and competition law. In the case concerning the opening of markets for consolidation services in the German postal system, the conflict arose from differences in the relevant legal norms. In the cases concerning market squeezes in telecommunications, the conflict arose from differences in attitudes of the different authorities.

5. There are several reasons why sector-specific regulators and competition authorities may take different views of the same issue. First, whereas the sector-specific regulator is concerned with one industry and with the legal norms governing that particular industry, competition authorities are concerned with abstract rules that apply to all industries. Where one institution thinks about coherence in terms of policies for “its” industry, the other institution is concerned with coherence in the application of “its” rules across all industries.

6. Second, the different approaches taken by the different institutions often reflect differences in political embeddedness. Sector-specific regulation tends to be more prone to regulatory capture than competition policy. In an industry that is subject to sector-specific regulation, industry participants are constantly dealing with their regulator. They have strong incentives to invest in their relations with the institution and with political players that may put pressure on the regulator. By contrast, industry participants are not constantly dealing with the competition authorities and have much weaker incentives to invest in good relations there. On occasion, e.g. in the context of a merger case, they may...
try to mobilize allies in the political system, but these efforts are much less pervasive and on the whole less effective than the efforts of participants in regulated industries.

7. When sector-specific regulators and competition authorities take different views of what is basically the same set of issues, the resolution of the conflict depends on legal intricacies. In a homogeneous legal system, the question is whether the issues are so much “the same” that many competition rules are superseded by sector-specific law under the *lex specialis* principle. In the hybrid legal system of the European Union, the question is how the rule of sector-specific national law under European Directives relates to competition law, which is contained in the Treaty and is directly applicable. In the cases discussed above the ultimate outcomes were very much driven by legal and administrative details involved in these questions, such as the assessment that a behavior of a dominant firm that has been approved by the sector-specific regulator can still be prosecuted under competition law if the firm had some discretion in its application to the regulator.

8. It is not a coincidence that among the different regulated industries, conflicts between sector-specific regulators and competition authorities have been most pronounced in the network industries. In these industries, sector-specific regulation is directly concerned with competition issues, such as prices and non-price features of access to the essential facilities that participants rely on to compete in “downstream” markets. Therefore there is a great deal of overlap with competition authorities’ concerns in these industries. In other regulated industries, the overlap in terms of competition concerns is smaller, so *prima facie* there is less potential for conflict. In some instances though, the conflicts are merely different and so are the arenas in which they arise.

9. One example is the financial industry. The financial industry has been subject to sector-specific regulation at least since the Great Depression. Over time, however, the nature of regulation in this industry has changed a lot. In the distant past, in many countries, the banking sector was exempt from competition law, and much regulation was designed to impede competition, in particular price competition, and to enable banks and other depository institutions to earn sizeable profit margins. Between the mid-1970s and the mid-1990s, much of this old regulation was dismantled. New rules that were put in place were intended to protect the banks’ creditors from risks. In the financial crisis of 2007/2009, these rules proved to be insufficient so they were tightened; in addition many new rules were put in place, sometimes through regulatory fiat, rather than legal changes.

10. In the following, I discuss the relation between sector-specific regulation and competition policy in the financial sector. I begin with a discussion of characteristics that make competition policy different from regulation.

### 2. Competition Policy and Sector-Specific Regulation: Some General Observations

11. The very term *competition policy* must be used with some caution. Economists trained in the tradition of Pigouvian welfare economics tend to think of “policy” as a line of intervention intended to correct certain distortions in order to promote the realization of efficient outcomes. This way of thinking neglects the institutional and procedural aspects of policy design and implementation. This way of thinking also neglects the pitfalls of a *dirigiste* approach to the attainment of desired market outcomes.

12. At the level of implementation, competition policy is not actually a policy in the usual sense of the word, but an application of competition law, subject to being reviewed
by the courts. As a rule, competition law is formulated in abstract terms, without reference to the details of any particular industry. Moreover, competition law is formulated in terms of prohibitions: Market participants must not form cartels. Firms must not engage in mergers that would create or reinforce dominant positions. Dominant firms must not engage in exploitative, discriminatory or anticompetitive forms of behavior. These rules tell market participants that there are certain things they must not do; none of them tells market participants what they should do.

13. In contrast, sector-specific regulation prescribes certain modes of behavior. Owners of network infrastructures are mandated to grant access to potential competitors at appropriate prices. Banks are mandated to maintain their funding by equity and/or certain forms of long-term—“bail-in-able”—debt at specified proportions relative to their assets. Thus in 2016, the supervisors told the Italian bank Monte dei Paschi di Siena to increase its equity by at least €8.8 billion, a very specific mandate.

14. Bank supervisors can also approve or disapprove business practices even when these business practices are not mentioned in the underlying legal norms. Thus, in the run-up to the financial crisis, the supervisors in some countries allowed “their” banks to create special purpose vehicles in order to hold structured investments off their balance sheets and supervisors in other countries did not; these differences in administrative practice were due to differences in politics rather than legal norms.\(^9\)

15. When a competition authority decides on a case, it must show that the case is appropriately subsumed under the existing law. The question is not how the incriminated behavior relates to whatever may be the ultimate or even intermediate policy objectives of the authority, but whether the behavior falls under the law’s prohibitions. To the extent that the authority has its own views about policy objectives, it may be tempted to act in accordance with these views, but then it must be afraid that its decisions will be overturned in court. Complaints by the incriminated parties are always in the cards, in cases of anticompetitive abuses and mergers also complaints by those parties’ competitors.

16. How seriously the concerns about subsequent court proceedings are taken depends on the attitude of the courts. In some jurisdictions, the courts require the competition authorities to provide material proof of the fact that their decision was “right”; this is the case, e.g. in Germany, to some extent also in the United States.\(^11\)

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\(^9\) The German legislator’s attempt to cast this mandate in the language of competition law was singularly ineffective. “It is an abuse of dominance to deny access to an essential facility at an appropriate price” (Art. 19, (4) Nr. 4 of the Law against Restraint of Competition) begs the question of how access should be granted, in particular what price is appropriate. Given the importance of fixed costs in infrastructure and the fact that there is no single “right” way of attributing fixed costs, the task of proving in court that the mode of access demanded and the price imposed are appropriate is insurmountable. See Hellwig (2009), l.c. (n. 4).


\(^11\) The authority’s burden is sometimes lightened by presumptions of facts named in the law, e.g., in the German Law against Restraints of Competition the presumption that a market share of 33 % is sufficient for a dominant position. A firm with a market share above the threshold might still try to “disprove” the fact that it is dominant, but this attempt is likely to be just as futile as the competition authority’s attempt to “prove” that a firm with a market share below the threshold is
proceedings before the European Court of Justice, the Commission must only show that its decision was not taken arbitrarily and was based on substantive reasoning.\textsuperscript{12} The Commission thus has more discretion to engage in “policy”, but even there, the reversals it has suffered in court show that its discretion is limited.

17. Economists have long been critical by the extent to which the implementation of competition policy has been dominated by legal concerns and legal traditions. If one thinks of competition policy as a set of interventions aiming to improve the “efficiency” of market outcomes by removing distortions from the exercise of market power, one may want to avoid those interventions that actually reduce “efficiency”, injunctions against “anti-competitive abuses” that merely protect competitors from the effects of the incumbent’s superior performance or prohibitions of mergers that improve “efficiency” by enabling firms to better exploit economies of scale and scope.

18. In this discussion, it is important to distinguish between the objectives of competition policy, the substantive reasoning used and the procedural approaches taken. At the level of objectives, criticism of competition authorities from the economists’ point of view has little merit. The notion that “efficiency” is an objective of competition policy has no basis in the legal norms and their history. In the United States, passage of the Sherman Act was motivated by populist revulsion against price-fixing and the power of the trusts. In Germany, which provided the main impetus for the competition chapter of the Treaty, the ordoliberal school pushed antitrust legislation with a view to protecting competition as an essential element of economic freedom.\textsuperscript{13} Article 101 TFEU does allow for efficiency considerations, but such considerations are not allowed to overturn the per se prohibition of hard-core cartels and, moreover, the efficiency gains must not be achieved at the expense of consumers.

19. The economic approach does have merit at the level of substantive reasoning, where all too often certain forms of behavior have been outlawed without much understanding of the effects - and without much concern for the possibility that a dominant company might in fact be a very effective competitor in its own right.\textsuperscript{14} Even if one accepts the procedural argument that \textit{per se} prohibitions and \textit{per se} admissions of

\textit{nevertheless} dominant. Such procedural effects explain why merger control is so concerned with market shares.

\textsuperscript{12} To some extent these differences explain why the Boeing-McDonnell merger was treated differently by European and American authorities. See W.E. Kovacic, Transatlantic Turbulence: The Boeing-McDonell Douglas Merger and International Competition Policy, \textit{Antitrust Law Journal} 68, 805 ff.


specified forms of behavior provide the addressees with legal certainty, the substantive reasoning supporting such distinctions should involve valid economic arguments rather than merely an antipathy against unfamiliar forms of behavior such as non-linear reward or rebate schemes. For the discussion here, it is of interest to note how far these disputes about the role of economics in the implementation of competition policy are removed from anything in the debate about financial regulation.

20. Sector-specific regulators are both stronger and weaker than competition authorities. They are stronger because, by its very nature, sector-specific regulation involves important elements of discretion, and this is allowed for in the underlying legal norms and legal practice. For example, a network regulator’s assessment of a proposed access price requires some judgment about the appropriate allocation of the fixed costs of the infrastructure over the different activities for which the infrastructure serves. A bank supervisor’s assessment of the quantitative model that a bank uses to assess risks in its trading book requires some judgment of what the risks actually are and whether the model is able to quantify them properly. The more an authority has to do with the ongoing management of the firms that it supervises, the more discretion it needs in its dealings with the firm.

21. However, the very closeness of regulatory authorities to the institutions they supervise is also a source of weakness. The closeness breeds familiarity, which may provide a basis for capture. Capture is also facilitated when the political system takes a strong interest.

22. In contrast to competition authorities, financial supervisors are not hit by many legal complaints. I do not see this observation as indicating that their legal positions are that much stronger. I rather suspect that they are more prone to shy away from conflicts. In personal discussions, I have received the impression that legal concerns play at least as much of a role with financial supervisors as with competition authorities. In addition, the strong interest that politicians and the public take in the availability of funding from banks and other financial institutions makes it hazardous for a bank supervisor to impose restrictions that might constrain bank lending.

3. Banking Regulation and Supervision: An Overview

23. Banking regulation has a strong anti-competitive tradition. For a long time, it was dominated by the view that competition in banking tends to be ruinous and must therefore be prevented. To some extent this view reflected experiences in the Great Depression when banks fearing runs tried to attract deposits by raising the interest rates they offered, thereby depressing profits and making depositors even more concerned about bank solvency. In the United States, this experience was one reason for introducing Regulation Q, which prohibited depository institutions from paying deposit rates above specified levels.

24. Between 1935 and 1975, between the Great Depression and the inflation of the 1970s, banking regulation and supervision in most OECD countries involved the

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following elements: Explicit or implicit government guarantees of deposits, restrictions on deposit rates, alternatively a toleration of interest rate cartels, restrictions on entry, market segmentation, asset allocation rules with minimum reserve requirements, quantitative limits on lending to the non-financial sector, mandates to invest in home mortgages or in government debt, and prohibitions on cross-border investments.\textsuperscript{16} Ostensibly, these measures were intended to reduce risks in banking and to prevent a repetition of the depression-era banking crises. In fact, they served to promote government borrowing, home ownership and other activities that the political system considered desirable.\textsuperscript{17} Restraint of competition for funds played a key role because it provided the basis for cheap lending by the banks.

25. Between the 1970s and the 1990s, most of these earlier regulations were dismantled.\textsuperscript{18} The deregulation was motivated by perceptions of risks attached to the old rules and of new opportunities. The changes in perceptions were induced by two developments. First, the macroeconomic environment had changed: By 1975, trade imbalances, oil price increases, fiscal deficits, and inflation had caused the Bretton Woods system of fixed exchange rates to be abandoned, had caused a need for petrodollar “recycling”, and had caused a dramatic increase in market rates of interest that undermined the viability of institutions subjected to deposit rate regulation. Second, institutional and technological innovations, in particular the development of money market funds, dramatic improvements in information and communication technologies, and the development of techniques for managing derivatives, eroded past systems of market segmentation and at the same time opened new fields of business.

26. Competition was an important part of the story. In the United States, Regulation Q was abolished when it threatened the viability of depository institutions in competition with money market funds in the early 1980s, at a time when market rates of interest were at an all-time high. In the European Union, financial deregulation was driven by the need to make financial institutions ready for cross-border competition as changes in communications technologies were eliminating the effects of distance and of national borders, e.g. in securities trading and, moreover, the existing legal barriers to entry by institutions from other Member States were about to be abolished under the auspices of the Internal Market program.

27. Political discourse about deregulation was driven by perceptions of opportunities as well as threats. The abolition of capital controls after 1973 made room for vast amounts of international lending (petrodollar recycling); the opening of derivatives markets provided US commercial banks with an opportunity to erode the limits to their activities that had been set by Glass-Steagall; and the Big Bang of 1986 reflected the


\textsuperscript{17} In some countries, financial repression through regulation contributed substantially to government finance. See the papers by F. Bruni (for Italy), R. Caminal, J. Gual, X. Vives (for Spain), and A. Borges (for Portugal) in: J. Dermine (ed.), \textit{European Banking in the 1990s}, Blackwell, Oxford 1990.

aspirations of the London Stock Exchange to become the premier trading institution for the stocks of large corporations from Europe, if not the world. Policy makers harboring industrial-policy aspirations shared the sense of opportunities without however abandoning the view that financial institutions should be available to fund whatever they liked to be funded and to do so cheaply. The implications of the intensification of competition for the viability of financial institutions had hardly been taken in.

28. By the early 2000s, the system of financial regulation had been completely changed. Regulation now focused on rules for capital adequacy, i.e. minimum requirements for the equity that banks must use to fund their activities. Under the auspices of the Basel Committee for Banking Supervision, these rules were agreed on internationally. For banks from countries adhering to Basel rules, cross-border activities were governed by the home country principle. Equity requirements were calibrated towards the risks inherent in the banks’ assets and derivatives, with banks’ own quantitative models and internal credit ratings serving as a basis for assessing these risks. In line with earlier thinking about politically desirable asset allocations, lending to sovereigns and real-estate lending were given reduced risk weights. Moreover, despite the experience of American depository institutions in the 1980s, the risks from using short-term liabilities to fund loans and mortgages in the bank book were largely ignored.\footnote{For an overview over regulatory developments, see A. Admati and M. Hellwig, The Bankers’ New Clothes: What’s Wrong with Banking and What to Do about It, Princeton University Press, Princeton, N.J. 2013, Ch. 4, 6, and 11.}

29. All these developments contributed to the very large growth of the financial industry relative to the rest of the economy.\footnote{For a documentation of developments since the mid-1990s, see Advisory Scientific Committee, Is Europe Overbanked?, Report 04/2014 of the Advisory Scientific Committee of the European Systemic Risk Board, Frankfurt 2014.} Relative to GDP, bank lending and bank assets in OECD countries grew dramatically in the years before the financial crisis. For example, between 1996 and 2007, in Europe bank assets relative to GDP grew from less than 200 percent to about 350 percent. Most of this growth is accounted for by the very large banks. Moreover, much of it was funded by borrowing. Whereas “risk-weighted” regulatory equity ratios remained roughly constant between 1996 and 2007 (as one would have expected), unweighted equity ratios, i.e. equity relative to total assets declined steadily, from about 6 percent in 1996 to about 3 percent in 2007. (Since then, the unweighted ratios have gone up again but on average they are still no higher than they were in the mid-1990s.)

30. Some of the expansion was directly connected to regulatory measures motivated by industrial policy objectives such as the promotion of national champions. For example, the German Pfandbriefgesetz (Covered-Bond Law) of 2005 liberalized entry into the segment of banks that invested in real-estate and public-sector lending and funded themselves by issuing covered bonds as well as unsecured debt (for the excess of the collateral over the nominal value of the covered bonds). The law was intended to provide the Landesbanken with additional business. Consequently, capacity in the covered-bond segment of the system expanded greatly, competition became even more intense than it had been previously. In order to survive in the market, participants had to offer conditions to borrowers that allowed them to earn margins above funding costs only if they engaged in extreme maturity transformation. For banks that did not have strong funding by deposits, such as Dexia of Hypo Real Estate, that meant funding the excess coverage by
borrowing in the money market, a strategy that proved fatal in September 2008, when money markets froze.\textsuperscript{21} Similar industrial policy and lobbying motivations may be attached to supervisory authorizations to hold assets in special purpose vehicles outside of the banks’ balance sheets in order to circumvent equity requirements and to exemptions of repo loans from bankruptcy rules.\textsuperscript{22}

31. The financial crisis indicated that some of the deregulation had gone too far. The subsequent reforms, in particular “Basel III”, the reform agreed by the Basel Committee on Banking Supervision in 2010, raised the required ratio for equity relative to risk-weighted assets and introduced a leverage ratio requirement, with a lower bound on equity equal to 3 percent of total assets. Basel III also introduced a liquidity coverage ratio and a net stable funding ratio, thus limiting the extent of liquidity transformation and maturity transformation that banks could engage in. However, the basic structure of the regulatory architecture was not changed: The major focus is still on equity requirements calibrated to risks, as assessed by the banks’ own quantitative models and internal ratings. Regulation of internationally active banks is still governed by the home country principle, though some countries, notably the United States, have begun to engage in some ring-fencing, i.e. requiring foreign banks to organize their activities in legal forms that make them subject to local regulation as well as regulation and supervision in their home countries.

32. There has however been an important change in the way supervisors go about their business, at least in Europe. Driven by a sense that damage from “the crisis”, more precisely, the sequence of crises ranging from the fallout of the subprime crisis in the United States to the various real-estate, sovereign-debt and banking crises in Europe has not really been fully cleaned up, supervisors have become more active, imposing add-ons to the basic “Pillar 1” capital requirements, asking for information, questioning asset valuations and business models and so on. Whereas before the crisis, “Pillar 2” of the regulatory framework, a set of rules relating to the quality and professionalism of banks’ activities, was used sparingly, with a focus on what seemed to be rogue banks, over the past few years, supervisors have turned to invoking these rules on a regular basis for all banks, for multiple purposes, including a tightening of equity requirements.


4. Industrial Organization and Competition Policy Issues in the Financial Sector

4.1. Barriers to Entry

33. Market structures and modes of competition differ between different parts of the financial sector, in some cases also between countries. The differences reflect differences in technology and in history, which may perpetuate themselves because of inertia.

34. Barriers to entry have traditionally played an important role. Technical change and innovation have eroded some of them, but not all, and in some cases created new ones. The underlying causes come from technology, customer inertia and brand attachments, regulation, network effects and market foreclosure by incumbents.

35. **Technology:** At the retail level, entry into banking involves significant fixed costs and significant learning-by-doing effects. Getting close to customers, depositors as well as borrowers, by having a large network of branches covering space is expensive. As depositors transition to electronic communications, a presence in space becomes less important on the funding side, but much of the relevant information about borrowers, in particular, small firms is local. Moreover, much of this information only becomes available through learning by doing.

36. **Inertia:** For many retail customers, changing banks is expensive, so they may be unwilling to move. In some countries, certain banks have also been able to create significant brand loyalty. For example in Germany, the Sparkassen (savings banks) have established the image of being the banks for ordinary people, as opposed to the large banks, which are seen as the banks for rich people. The resulting brand loyalty translates into significantly higher fees, which is why the Sparkassen (and similarly the cooperative banks at the retail level) are the most reliably profitable segment of the German financial sector.

37. **Regulation:** Whereas outright entry regulation no longer plays a central role, more recent developments in regulation and supervision have added to the fixed costs attached to certain activities in the financial sector and have thereby contributed to raising barriers to entry. The Basel system of allowing equity requirements to be computed on the basis of internal models and ratings provides a competitive advantage to banks that are large enough to invest in the development of such models and, correspondingly, a disadvantage to banks that are too small for such investments to be worthwhile. Some organizations of smaller banks, e.g. associations of savings banks or of cooperative bank, have tried to overcome the disadvantage by investing in model development as a common venture, also by introducing risk sharing in order to take advantage of the risk-dependence of capital requirements. However, these devices have costs of their own. I also suspect that the recent “Pillar 2” activism of supervisors that I mentioned above is more burdensome for small than for large banks.

38. **Network effects and market foreclosure:** Participation of banks in payment systems have always been a source of network effects. Banks that did not participate could not offer their customers the same services at the same prices. For standard

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23 H. Hakenes and I. Schnabel, Bank Size and Risk-Taking under Basel II, *Journal of Banking and Finance* 35 (2011), 1436-1449, elucidate the mechanism and argue that the resulting competitive pressures on small banks may induce additional risk taking so that, even if the stabilizing effects of Basel II rules are taken into account, the net effect on financial stability can be negative.
payments, these effects have largely evened out because by now, in most OECD countries, practically all banks are part of the common national and international payment systems. For risk management purposes, however, the effects have become more important. A bank’s ability to offer an internationally active nonfinancial company appropriate management of its exchange rate risks depends on the bank’s participation in derivative markets. Given the importance of hedge strategies in these markets, this participation in turn depends on the bank’s belonging to the “club” of institutions with appropriate collateral, presumably managed by JPMorgan.

39. Network effects in payment systems may again come to play an important role as new payment systems based on blockchain technology gain in prominence. In this context an important question will be whether the promoters of the new technology will actually be able to enter the system on a permanent basis, or whether the power of incumbents to exploit network economies will enable them to get control of the new technology without admitting a significant number of new participants into the system.

40. **Summary:** The preceding observations can explain why we tend to see fairly concentrated market structures and oligopolistic pricing at retail levels and in some derivatives markets, but more fragmented market structures and highly competitive pricing in wholesale markets and in the markets for services related to asset management and securities investments.

### 4.2. Government Protection, Implicit Subsidies, and Merger Control

41. In the above overview, I mentioned government guarantees as an element of the system of financial regulation that prevailed between the 1930s and the 1970s. Deposit insurance as an explicit system of guarantees from institutions that had the backing of the national Treasury was actually special to the United States. Other countries had guarantees for some institutions, e.g. Germany for public banks, but most countries did not institute anything like the Federal Deposit Insurance Corporation. (In parentheses: Instituting such a scheme would probably have led to calls for more intense regulation and supervision.) But in all countries, there was a memory of the Great Depression, with banking crises that had badly damaged the overall economy and created needs for government interventions if only to keep normal life going. There also was an understanding that, if a system wide crisis put the well-being of the overall population at risk, no government would be able to withstand the demand for public support. When such an understanding is present, participants act as if there was an implicit guarantee from the government.

42. A paradigmatic example is provided by the “government-sponsored entities”, Fannie Mae and Freddie Mac, in the United States. These had originally been created as public institutions to support the funding of home ownership. When they were privatized in the late 1960s, they still were “government-sponsored” in that they had access to the US Treasury for liquidity support. Among investors at large, there also was a sense that their debt was guaranteed by the US government. In fact, there was no legal norm to this effect. Both institutions were private, subject to standard bankruptcy law. In the crisis of 2008, however, they ended up being bailed out by the government after all. Politically, if not legally, they were too big to fail.

43. In the United States, the two decades before the financial crisis saw many bank mergers and a significant increase in concentration in banking. To some extent, this development reflected the dismantlement of rules, such as the prohibition of interstate
banking, that had artificially kept banks small and the banking sector fragmented. To some extent, the development reflected the thinking of Chairman Greenspan, that market power was a source of profits and profits a basis for financial stability. The ability of US banks to earn (monopoly) profits at the retail level was thus much increased.

44. In addition, however, the prospect of becoming too big to fail provided important incentives for bank mergers. According to one study, in the years 1990–2004, the gains attached to such a prospect accounted about one half of the gains for shareholders of target banks in takeovers that put total assets of the merged institution above $100 billion.24

45. From a competition policy perspective, the important issue is not so much whether the bank will actually be bailed out in a crisis. The important issue is to what extent an anticipation of a bailout will make investors to provide funding more cheaply, and what are the competitive effects of such expectations.25 The estimates obtained in different papers on this subject differ, but they all agree that the numbers are large.26 For the years of the crisis itself, the estimated numbers are astronomical because in the crisis, private lending to banks was hardly forthcoming at all.

46. These considerations raise questions for merger control. One question is easy to answer: The US model of taking merger control for banks away from the competition authorities and assigning it to a sector-specific regulator (the Federal Reserve) has materially contributed to harmful developments in the twenty years before the crisis and must be deemed to have failed. Contrary to Chairman Greenspan’s view that bank mergers enhance financial stability, bank mergers in the United States have contributed to a perception that the institutions in question would be too big to fail. This perception has allowed these institutions to expand their leverage dramatically without having to pay the higher interest rates that increased risk from increased leverage would normally entail. A competition authority that is less prone to catering to the special concerns of the industry would probably have been less tolerant of this development.

47. The question has been raised whether merger control for the banking industry should not be tougher than for the rest of the economy. Shouldn’t the authorities be more critical about a bank merger that increases the prospects for government support in a crisis and thus generates (i) a fiscal cost (in expected-value terms) and (ii) a distortion of


25 Another important issue, relating to financial stability rather than competition, is whether an expectation of being bailed out induces the bank to take greater risks. For the latent crisis of 1990 in the United States, whose outbreak was prevented by the turnaround in US monetary policy, J. Boyd and M. Gertler, The Role of Large Banks in the Recent US Banking Crisis, Federal Reserve Bank of Minneapolis Quarterly Review 18 (1994), 2–21, shows that such behavior indeed played an important role.

26 For an overview, see Admati and Hellwig, l.c. (n.18), Ch. 9. Gandhi and Lustig discuss the impact of implicit guarantees on the returns of large versus small banks and estimate that the value of the implicit guarantees to the largest commercial banks in the US has been between $4 billion and $5 billion per year.
competition from the implicit subsidy to the merged bank’s funding than about a merger that does not have such effects.\(^{27}\)

48. There are two ways to think about this suggestion. One approach would call for a sector-specific form of merger control, an analogue of the US regime, but with a view to being stricter rather than laxer on bank mergers. Such an approach would abandon the advantages of a unified competition policy regime that applies the same rules to all industries. It might also end up being more prone to regulatory capture — even though the motivation for its introduction is the very opposite.

49. An alternative approach would try to subsume the concerns that have been raised under the existing legal norms. The distortion from the implicit subsidy to the merged bank’s funding might be treated as a “significant impediment to effective competition”, to use the relevant term of the EU’s merger control regime. Traditional interpretations of the term refer to the coordination of behavior of the merging units after the merger, but tradition should not prevent us from thinking about “impediments to effective competition” in more general terms. Subsidies that create uneven playing fields do create impediments for those market participants that are disadvantaged.

50. State aid control is not well suited to address the problem. The anti-competitive distortion arises long before any state aid is granted, merely from the anticipation be investors that, in a crisis, the government will support the institution in question — and its creditors. If such anticipations are based on explicit guarantees, state aid control can help by banning such guarantees, as the European Commission did for public banks in Germany and elsewhere with effect for any debt issued from 2005 on. In the absence of explicit guarantees, there are no grounds for state aid control to intervene — until the crisis actually occurs and the government steps in, as happened in many countries in 2007/2009. At that point, the case for government support as a means of averting large damage to the overall economy is so strong that the competition authority can hardly prevent the provision of state aid. Therefore the idea of at least attenuating the problems by taking it into account in merger control makes a lot of sense.

51. The preceding considerations concern mergers that take place before the system enters a crisis. We also should think about bank mergers in a crisis. Having a — hopefully — healthy bank take over a failing bank is a time-honored recipe for crisis management. In 2008, in the United States, this recipe was applied with a vengeance: JPMorganChase/Bear Stearns/Washington Mutual, Bank of America/Merill Lynch, Wells Fargo/Wachovia — the 2008/09 mergers made the largest US institutions become even larger, making the too-big-to-fail problem even greater.

52. In such a situation, a competition authority would hardly be in position to object. The underlying problem is that we do not have resolution regimes that we would confidently resort to without much fear of a system meltdown. It has therefore been suggested that competition policy for banks should perhaps have scope for mandatory divestitures and breakups as well as mergers.\(^{28}\) Given the very mixed experience of the United States with such a regime, I have some doubts about its workability. I also see a danger that the existence of such a regime might make healthy banks unwilling to acquire


\(^{28}\) Zimmer, l.c. (n25), discusses this possibility as well.
failing competitors: With such a regime in place, they would consider that they would bear the downside risk that the acquisition might end up as a failure and yet could not count on keeping the full benefits on the upside if the acquisition became a success.

4.3. Government Support and Lack of Exit

53. Whereas the European Commission’s assessment of guarantees for public banks as state aid had long been contested by the German government, this dispute came to an end in 2001, when the German government agreed not to contest the Commission’s prohibition of the guarantees and the Commission agreed that the prohibition would only take effect in 2005. The Landesbanken used the four years to issue new debt with state guarantees on the order €100–200 billion. A large part of the funds was poorly invested, in mortgage-backed securities and the like, which explains why the greater part of the costs of the crisis for German taxpayers came from the public banks rather than the private banks or the cooperative banks.29

54. Given the poor record of the Landesbanken over decades, I suspect that without the guarantees they would not have survived for so long.30 They entered the financial system around 1970 when the giro centers that handled the payment systems of the savings banks were turned into actual banks, using the funds deposited by the savings banks for lending of their own, rather than placing these funds in the money market. At that time, however, there was hardly any need for additional banking capacity, except that the heads of the Länder, the regional governments in Germany, liked the idea of having banks to which they could turn for parafiscal spending. Since their creation, there hardly has been a decade without a major scandal involving large losses from bad loans and investments. And there was no period when these institutions were able to earn substantial profits – despite the advantage of being able to obtain funding at interest rates reflecting the AAA ratings of their guarantors.31 Without that funding advantage, they would have made massive losses.

55. Their continued existence in the market, however, put pressure on other institutions, reducing their ability to earn sufficient margins at reasonable risks. Above, I mentioned that the expansion of the Landesbanken in the covered-bond segment of the financial system following the liberalization of 2005 forced other participants to engage in extreme maturity transformation in funding the excess coverage, thus exposing themselves to significant liquidity risk.32

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29 In Hellwig (2017), l.c. (n. 21), I list taxpayer costs of €51.4 billion from the Landesbanken, €9.6 billion from Industriekreditbank, in which the government-owned Kreditanstalt für Wiederaufbau held some 38 percent of the stock, and €17–20 billion from the private banks Hypo Real Estate and Commerzbank. Uncertainty about the bailout costs for the private banks is due to lack of information about the prices at which Commerzbank shares were acquired at different points in time.

30 By contrast, the success of the Sparkassen, the local public banks, is due to the brand effect mentioned above rather than the public guarantees.

31 Expertenrat, l.c. (n. 20), contains an account of their performance.

32 For theoretical and empirical work on the destabilizing effects of government guarantees on the beneficiaries’ competitors and thereby on the overall system, see H. Hakenes and I. Schnabel, Banks without Parachutes – Competitive Effects of Government Bail-out Policies, Journal of
56. The example illustrates a general problem: If there is excess capacity in a market, some exit may be called for. Lack of exit creates distortions. To be sure, no one really knows what capacity is appropriate, but if there are artificial barriers to exit, such as those caused by government support of unprofitable or even failing banks, and if the existence of weak institutions in the market forces others to take unconscionable risks, that constellation suggests that excess capacity is distorting market outcomes.

57. A simplistic view of competition and competition policy might suggest that the continued maintenance of excess capacity is all to the good as it forces market participants to provide customers with advantageous conditions, e.g. relatively low interest rates for loans and relatively high interest rates for deposits. This view, however, is flawed. The objective of competition policy is not simply to promote advantageous conditions for customers but to promote *appropriate* conditions, meaning that proper account must be taken of costs and risks. If competition is distorted by explicit or implicit government subsidies, market outcomes will reflect these subsidies and can therefore be quite inefficient.

58. Most of the bailouts that happened in the financial crisis prevented exit. To the extent that preceding developments had been driven by distortions from excess capacity, this underlying cause of the developments remained in place. The continuing low profitability of banks in Europe is not just due to the compression of interest rates through the ECB’s monetary policy but also reflects the lack of a cleanup and sufficient contraction of capacity since the crisis.

59. Lack of exit often involves the maintenance of “zombies”, banks that would be acknowledged as being insolvent if prospective losses on their loans were assessed realistically. The valuation of loans involves a certain element of arbitrariness. After all, the borrower’s difficulties might be only temporary, and he might soon recover. Such forbearance may well be justified but it tends to become problematic if it is driven by concerns about the bank’s own solvency or the reactions of the bank’s supervisors, rather than merely the business prospects of the borrower. If the problem concerns many banks, the supervisor may be willing to go along with such forbearance; otherwise he might have to deal with a system crisis in which a large part of the industry must be wound down or restructured, with substantial effects on bank lending and the real economy. And he might face the question of what he had been doing while the risks were building up.

60. Past experience suggests that, in such a situation, it is usually better to go for a cleanup right away rather than let the problems linger and hope they will go away on their own. Sweden, which did intervene promptly in 1992, had a sharp recession, but that was followed by a quick recovery, to which the restored health of the banking system contributed. The United States, which did not intervene with their savings institutions in 1981, paid a large cost when in the late eighties the crisis came back with a vengeance.


33 Advisory Scientific Committee, Forbearance, Resolution, and Deposit Insurance, Report 01/2012 of the Advisory Scientific Committee of the European Systemic Risk Board, Frankfurt 2012.

34 See Admati and Hellwig (2013), l.c. (n. 18), Ch. 4 and the references given there. T. Curry and L. Shibut, The Cost of the Saving and Loan Crisis: Truth and Consequences, FDIC Banking
Japan chose forbearance in 1992 and also paid dearly because the weakness of the banking system and the maintenance of weak nonfinancial companies by weak banks contributed to the very low productivity growth in the following decade.\textsuperscript{35} I suspect that some of the low growth that we have seen in the European Union since 2008 reflects similar mechanisms. The situation of Italy, with more than € 300 billion in non-performing loans, is particularly worrisome.

61. In this context again, explicit or implicit government guarantees and subsidies play an important role. The ability of US savings institutions to survive for another decade in the 1980s was facilitated by the existence of statutory, government guaranteed deposit insurance. Because of this system, depositors had no incentive to look into the solvency of “their” savings banks. Indeed, by advertising with high rates “federally insured” savings institutions were able to expand greatly, which ended up raising the costs to taxpayers when the reckoning came.

62. In the case of the Italian banks, we have had a number of instances, where institutional investors in subordinated debt or preferred stock had withdrawn a few years ago and had been replaced by retail investors to whom subordinated and hybrid forms of debt were sold without much of a warning about the risks involved. In the case of Monte dei Paschi di Siena, the supervisors’ toleration of such practices was seen as inducing a co-responsibility of the government, with the consequence that one half of the losses imposed on subordinated debt was compensated by the government (in addition to the government’s contribution to the recapitalization).\textsuperscript{36} The nexus between government guarantees, continued funding, including non-deposit funding, and the delay of cleanup and exit played a big role there.

63. In recent years, the European Commission has taken a more restrictive view of such interventions by governments in support of “their” banks. In particular, the approval of government injections of equity is conditioned on there being some private-sector participation, be it in the form of additional equity or in the form of bailing in debt, as in the case of Monte dei Paschi. In combination with the tougher stance taken by the Single Supervisory Mechanism to asset valuation, this development contributes to getting the cleanup going, possibly also the exits that are needed.

64. However it is not clear that the state aid framework is well suited for the purpose. I see two problems. First, procedures take long. Cases of state aid control in the financial sector have tended to involve lengthy negotiations, extending over many months, in some cases even years. The very length of these negotiations may contribute to exacerbating the problems as additional investors are given the time to withdraw their funding from the banks forcing the banks to liquidate assets, which reduces payouts to creditors in a liquidation. If the bank goes into resolution after all, its position may therefore be much weakened; in liquidation, payouts to remaining creditors are reduced. The detrimental effects are reinforced by the fact that liquidation is likely to be concentrated among those


\textsuperscript{36} For an overview, see M. Hellwig, Precautionary Recapitalizations: Time for a Review, Preprint 14/2017, Max Planck Institute for Research on Collective Goods, Bonn
assets where sales prices are not much below book prices, in particular cash and cash-like claims.\textsuperscript{37}

65. Second, the Commission’s state aid control focuses on the distortionary effects of the support given to the particular institution under discussion. In the cases of Banca Popolare di Vicenza and Venetobanca, the government’s bailing out senior unsecured creditors was seen less critically. Because the parts of these banks that had not been sold to Intesa Sanpaolo were due to be liquidated, i.e. the banks were due to exit from the market, the bailout was deemed not to have much of a distortionary effect on competition in the Internal Market. This argument neglects the signaling about the government that is involved. The bailout as such may not have had much of a distortionary effect but the information that here again the Italian government was willing to put taxpayer money at risk in order to protect the holders of senior unsecured debt does have a distortionary effect on competition. The measure provides another signal that, despite the various proclamations of principle concerning the need to bail in creditors and despite the legal codification of these principles in the Bank Recovery and Resolution Directive and in the Single Resolution Mechanism Regulation, debt holders can still expect to be supported by a bank’s government. These considerations suggest that the state aid control should be concerned with distortions to competition in the Internal Market in terms involving signaling about government policies towards the industry as well as the immediate role of the particular bank under review.

5. Concluding Remarks

66. The findings of the preceding discussion can be summarized as follows.

67. First, competition policy and sector-specific regulation are two very different activities. Competition policy involves the application of abstract legal norms, most of them prohibitions, subject to judicial review, without much leeway to take account of the special features of an industry. From the perspective of any one firm, interaction with competition authorities tends to be rare. Financial regulation and supervision, like other sector-specific regulation involves continuous oversight, some of it involving explicit directions on what participants should do.

68. Relations between the two sets of authorities are naturally antagonistic. Where competition authorities are used to saying “NO”, sector-specific regulators care about maintaining a workable ongoing relation with their firms. Capture is common, whether at the level of the regulator as such or by invoking the political system.

69. Such antagonism is likely to be useful as “untoward” interventions of competition authorities can contribute to keeping the sector-specific regulators honest. This observation militates against any imposition of cooperation that would force the competition authorities to submit to pressures.

70. The tradition of financial regulation has little to do with the promotion of competition. Even financial stability concerns have often been given lip service only. Usually the main concern of the political system, including voters, is to get financial institutions to fund things they like and to get that at convenient terms.

\textsuperscript{37} On biases in the selection of assets to be liquidated, see A. Admati, P. DeMarzo, M. Hellwig, and P. Pfleiderer, The Leverag Ratchet Effect, \textit{Journal of Finance} 2018, Section 4.
71. Important distortions of competition are due to explicit and implicit government guarantees and the way these guarantees affect behavior. In particular, too-big-to-fail policies create artificial incentives for bank mergers, which competition policy should seek to take into account and counteract. Once institutions are seen as being protected by governments, they have significant funding advantages. These advantages distort competition and can cause important misallocations of resources (and costs for taxpayers).

72. Implicit government guarantees stand also behind the common practice of delaying cleanups at problem banks and preventing exit. In this area, state aid control is called upon to work in a more timely manner and to take a more systemic view of cases, so that investors no longer have reason to take government bailouts for granted.

73. Whereas in most other areas of competition policy, the authorities major problem is to ensure that there is enough competition, i.e., that competition is not extinguished by cartel agreements, market foreclosures, or mergers, in banking and finance, they must also deal with the problem that there may be too much competition in the sense that government subsidies enable excess capacities to be maintained, and de facto insolvent institutions to remain in the market. Such constellations bear serious risks as the incentives of “zombie” institutions are greatly distorted and the competition from these institutions may force healthy institutions to engage in unconscionable risks.