Competition policy in a financial and economic crisis

Report of Competition Commission Roundtable held at Victoria House, London, on 30 March 2009

1. The current financial and economic crisis has deeply affected the global economy and prompted many countries across the world to examine many areas of policy. Most competition authorities are examining carefully how they should apply competition policy in the crisis.

2. The breadth and experience of the membership of the Competition Commission (CC) makes it particularly well placed to engage in this examination. On 30 March 2009 the CC held a Roundtable, attended by many of its members, by non-members including two distinguished competition economists, Sir John Vickers and Dr Mark Williams, and by representatives from other authorities including Dr John Fingleton, Chief Executive of the OFT. The Roundtable assessed how the current crisis might affect the application of competition policy in the UK and the work of the CC more specifically. Participants were invited to put forward a range of differing views to facilitate a full debate. This document summarizes the debate; a list of those who attended, and of the principal speakers, is attached.

3. The Roundtable covered four broad topics:

   - the origins of the current crisis;
   - the implications of the crisis for competition policy in the financial sector;
   - the implications of the crisis for competition policy in the broader economy; and
   - what the position of the CC should be during the current crisis.

Topic 1: The origins of the current crisis

4. **Sir John Vickers (Oxford University)** spoke first on the nature of the current crisis, expressing the view that it was the result of massive macroeconomic imbalances, combined with woefully 'mis-regulated', rather than 'under-regulated', financial markets. These imbalances were the result of huge savings in East Asia and oil-producing states, which flowed into Western assets. This was combined with loose monetary policy internationally, especially in the USA. In 2007, sub-prime defaults began and credit spreads among the banking system and the securitized assets were affected. Banks then started no longer to trust each other fully. There followed a phase where it was hoped that this was just a confidence or liquidity problem, but by early October 2008 it became clear that there was a systemic solvency problem. The liquidity and capital injection measures, and partial and total nationalizations, in the autumn were all about getting the capital cushion into the banks. Phase 2 was to get them lending again.

5. As to competition policy, he saw no reason to believe that letting through more anti-competitive mergers or more anti-competitive agreements, refraining from pro-competitive remedies in market investigation cases, or tolerating more abuses of market power, would be good for macro-economic performance. He pointed out that higher mark-ups were like a tax and were the opposite of what was needed. A recession 'bring[s] all the vested interests to life', but competition authorities should stand firm.

6. **Christopher Smallwood (CC member)** agreed on the origins of the crisis, but on the duration of the crisis he reminded the session that those excess savings were not going to go away any time soon. He predicted that there would be difficult economic times for more than a year or two, outlining a number of reasons, among them inadequate rates of credit growth, rising household saving, rising unemployment and the prediction that, despite the fall in sterling, the exporting sector would not recover and world trade was forecast, by the IMF, to shrink. He predicted that the next ten years would be very different from the last ten years—with chronically high unemployment—and would look a lot like the 1980s.

7. On the origins of the financial crisis, **Dr Mark Williams (NERA)** observed that the incentive functions facing bankers were such that they benefited on the upside, but did not suffer the downside, so were willing to make one-way bets. Shareholders should have done something about that, but did not and now had lost all their money, perhaps demonstrating that the market did work! He set out why the principles of competition policy and enforcement should not be softened in response to the recession. Economies could malfunction for all sorts of reasons and competition policy was designed to tackle only the market power problem, leaving other problems to be tackled with the appropriate policy instruments. Competitive markets, at least in a microeconomic sense, led to higher output, which was normally good for employment.

8. **Jonathan Whiticar (CC member)** saw the crisis as one in a long line of 'mis-selling and other losses suffered by consumers, including Equitable Life policyholders and the Lloyds insurance names' .

9. **Anthony Stern (CC member)** added that off-balance-sheet finance and regulatory reporting issues contributed to the current situation. In the corporate world the emphasis moved over time from 'cash is king' to 'gearing is the thing'. Some bankers, he said, encouraged borrowers to take on very optimistic levels of debt. Accountants and regulators did not fully spot the potential impact of such excessive risk taking.

10. **Dr John Fingleton (OFT)** made the point that it was not obvious that the problem in the financial sector was too much competition, but rather how incentives were channelled. The regulatory framework needed to be designed to channel the incentives in the right direction. He also stressed that mavericks and entrants were generally a positive force for competition and that new players, like HBOS's previous model in the personal current account market, could have real beneficial effects in the market. It was very difficult to find situations where giving an industry monopoly rent was preferable to other policy instruments. While the normal phenomenon of inefficient firms exiting was difficult in banking and the financial sector, given systemic risks, it could happen in the form of a takeover or through the Bank of England's new power to restructure companies.

11. **Professor Alan Gregory (CC member)** agreed that there was a strong case for more competition in the financial sector, not less—with the two exceptions being in relation to lending criteria and organized markets for some derivative products, as these parcelled up risk on a very large scale and should be traded in a more regulated way with proper market mechanisms, such as clearing houses and standardized contracts.

12. **Professor Jonathan Haskel (CC member)**, along with a number of other speakers, pointed out the importance of exit by poorly-performing firms who were replaced by better companies as one of the key ways in which competition worked. He acknowledged that this could not be allowed on any scale in the banking industry, as there could be a systemic disaster that would affect the whole economy, but referred to

John Kay's suggestion that the utility side be separated from the casino side, with the casino side being allowed to fail, as one possibility.

13. **Mr Andrew Rees (BIS)** queried whether the fact that the recession was characterized by not just falling demand, but a major market failure in relation to access to finance, meant that the normal benefits of creative destruction did not feed through and other effects should be taken into account.

14. **Professor Bruce Lyons (CC member)** pointed out that the exit process only worked well if financial markets were functioning well enough to bridge time horizons and provide finance and that a credit crisis disproportionately affected small firms as they tended to be more reliant on bank finance.

Topic 2: The implications of this crisis for competition policy in the financial sector

15. **Dr John Fingleton** stated that it was the credit crunch, not the recession, that was the issue here: the pressure came from the availability of credit and access thereto. Through this period we learned that: regulation had missed some things; in a crisis financial stability trumped competition, at least in politicians' minds; and that even 'sophisticated consumers' (ie big buyers) could get it wrong. He stressed that the pre-existing focus on the three themes of behaviour and rivalry, barriers to entry and horizontal issues would continue in the upturn. We would, however, see more focus on buyer behaviour by regulators and attempts to understand the dynamics of the sector, not least in light of some of the short-termism seen among institutional investors in banks. He stressed that competition advocacy would become increasingly important, as the benefits and dynamics of competition were not well understood in financial regulation. He warned that regulators were likely to focus more on level playing field disputes between incumbents rather than on bigger picture issues of incumbents versus entrants, even though entrants had a potentially greater effect on efficiency and innovation. Arguments about restricting entry to 'keep standards high' needed to be resisted. Competition was not part of the problem and the response had to be precise and surgical, not disproportionate and conscious of the risks of over-regulation: the design of a long-term regulatory structure was hugely important.

16. **Dr Peter Davis (CC Deputy Chairman)** made the point that the key question was whether we could design a regulatory system, on the competition side and on the financial stability side, that could channel competitive forces in a way that generated good outcomes for consumers of loans and savers. It was essential that financial stability imperatives did not stop the positive outcomes from competition. He stressed the importance of maintaining section 160 of the Financial Services and Markets Act 2000, which gave the OFT and the CC a role in advising on the effect on competition of changes in the regulation of financial markets. He also suggested a mechanism, a 'banking stability credit', akin to carbon credits, to tackle the financial stability externality, with banks being obliged to hold an asset which was related to the riskiness of their activities, ie they must hold more if they had a lower relative position for, say, tier one capital. He said that the pure regulatory solution was one route to the financial stability imperative, but the closest to the market solution was to invent assets that markets could price so that risk could be (1) constrained and (2) distributed across banks in an efficient way without the need for overly detailed regulation, which might stifle innovation and stop the positive effects of competition.

17. **Professor Alan Gregory** questioned the idea that organizing combinations provided a co-insurance against bank failure; there were several problems with that, not least

that it meant more banks became 'too big to fail'. He said that there was no compelling evidence that these concentrations benefited consumers or reduced contagion risk. The Buiter/Krugman 'good bank' model was his preferred solution, but might involve nationalizing and reprivatizing, which could achieve a very pro-competitive outcome if it created smaller good banks and none that were too big to fail, with managers, shareholders and bondholders suffering the consequences of their actions, while depositors were protected. He also warned that banks would be tempted to earn excessive profits in an attempt to rebuild their balance sheets and that lending was already becoming more expensive. He agreed that recapitalization was needed, but warned that if this meant excess profits then lenders and borrowers got a bad deal and the recovery was not helped. He was in favour of encouraging more competition on spreads, high rates for savers and low borrowing rates, but not on slack lending criteria. He also advocated breaking up the integrated investment bank model, as this would be pro-competitive. He concluded that economic efficiency required a very competitive banking sector where fair margins were being earned and that this may be particularly important for smaller firms as they did not have access to bond markets. He warned that this would not come about in a world of large merged 'zombie banks', so nationalization and a 'good banking' model was required.

18. **Michael Straughan (FSA)** made the point that the FSA did not have a direct competition objective, but competition was not ignored within its policy-making—rather competition was considered in the overall balance of costs and benefits. He stated that, in considering the merits of any policy proposal, the FSA would not be averse to 'perhaps lessening competition provided that the [net] benefits exceeded the costs'.

19. **John Smith (CC member)** asked whether the FSA needed a clearer competition duty, like some of the sectoral regulators had, especially given the trend towards consolidation in financial services.

20. **Laura Carstensen (CC member)** pointed out that, while sectoral regulators often had a duty to promote competition, it was often one of many duties and might be swamped by the complexity of competing duties, in contrast to those of the CC and the OFT.

21. **Sir John Vickers** commented that when he was at the OFT: 'I learnt that markets worked less well than I thought they did. I also learnt that Government worked less well than I thought it did. The extent to which Government worked less well than I thought it did was however far greater than the extent to which markets worked less well than I thought they did.'

22. A number of speakers believed that the increase in the role of the state in the financial sector was fully justified by the externalities involved, with **Christopher Smallwood** saying that there was a case for nationalizing banks to guarantee a flow of credit for the wider economy where private management failed to provide this, as well as a role for the state in other sectors, for as long as the supply of credit was curtailed.

23. **Professor Bruce Lyons** pointed out that the banking sector was unique in having two characteristics. The first was the contagion issue in terms of confidence and solvency, especially if a big bank was involved. The second was that it provided the working capital that lubricated the whole economy. In relation to state aid, he observed that the European Commission was now well-versed in the 'market economy investor principle' (MEIP), which did not work terribly well, but we knew it

worked roughly. He said that state intervention was nevertheless worth risking if the alternative was just banks not lending and falling into a deeper crisis.

24. A number of speakers were of the opinion that the Government was wrong to let Lloyds buy HBOS, with **Sir John Vickers** pointing out that it was clear by early October that there was a problem of banks being systemically grossly under-capitalized rather than it being just a confidence problem. **Dr John Fingleton** said that traditional reasons for worrying about government involvement in competition issues, including merger decisions, were 'national champions' and protectionism, and pointed out that Lloyds/HBOS fell neatly into neither of these categories, so did not appear to open the floodgates on keeping companies British or creating domestic monopolies.

25. **Professor Mike Waterson (CC member)** was in favour of nationalization: 'as a temporary measure and with independent trustees keeping politics at a distance, it could be effective'.

26. **Jayne Almond (CC member)** asked whether proponents of nationalization thought that politicians were best placed to run a bank. There was also an issue of nationalized banks competing with non-nationalized banks which could create real regulatory problems if non-nationalized banks began to suffer.

27. **Jonathan Whiticar (CC member)** pointed out that the common man had been the biggest loser, as everyone's pension funds had suffered as bank shares had lost their value. Nationalizing the banks would wipe out any potential recovery that these shareholders had. Another reason to be wary of nationalization was to look at the history of it in the UK in the last 60 years, eg British Leyland.

Topic 3: The implications of the crisis for competition policy in the broader economy

28. **Professor Mike Waterson** outlined things that he thought were likely to happen. First, that the pound would remain depressed for a number of years, so weakening competition in the many sectors where the main competition came from abroad. In other areas where there was more competition we should see firms thinking about merging, potentially with greater use of the 'failing firm' defence. It might be tricky to judge where this was genuine and where it was opportunistic. He also drew attention to the increased tendency to cartelize in response to a recession, as more firms could survive in a cartelized industry. This may be disguised in the form of codes of fair competition or assistance for small business, which should be resisted.

29. In relation to the Great Depression, **Professor Mike Waterson** pointed out that there was a lot of legislation that reduced the impact of competition policy. He said that there were also a number of areas where we saw 'sticky' or 'administered' prices, very high price falls in competitive sectors, whilst more monopolistic sectors saw stable or rising prices and warned that we might see something similar now, with prices of globally traded commodities falling, but domestically-produced goods and services remaining quite sticky.

30. A number of speakers pointed out that cartelization was a problem to watch out for in a recession. **Professor Bruce Lyons** predicted that there was likely to be pleading for ordered restructuring of industries and firms colluding in capacity reduction, which should be resisted. He warned that the OFT needed to be cautious if faced with arguments from cartel members that high fines would put them out of business. In relation to the potential for abuse of dominance, he advised that the OFT should be

on the lookout for cases where a firm that was reliant on bank financing was teetering on the brink giving a dominant firm an opportunity to strike a knock-out blow.

31. **Dr John Fingleton** suggested that the UK should show some leadership at EU level in relation to the political independence of competition policy, and warned that government intervention in competition policy could lead to it circumventing the state aid system, but in a less transparent manner, and could lead to huge inefficiencies across markets. He pointed out that under a public interest test we could not have achieved the remedies for the airports or payment protection insurance markets. He was not in favour of a move back to a public interest test, as the independent competition system had worked very well.

32. **Anthony Stern** said that exits were not always a bad thing, and asked why, for example, the taxpayer should support major car manufacturers when insufficient customers wanted to buy their cars. He argued that the CC should oppose the 'public interest card'.

33. **Christopher Smallwood** put forward the view that the current competition regime was one for good times and that a broader, refashioned public interest test might be more appropriate to these changed times, with value judgements being left to the Secretary of State.

34. **Laura Carstensen** made the point that the CC was charged with taking competition questions in isolation, but society was reawakening to the fact that competition was part of a mosaic of public interest factors that needed to be weighed in any case and a judgement struck.

35. **Dr Mark Williams** suggested that attendees reminded themselves of the arguments put forward before the Enterprise Act 2002 for why a focused competition test was needed to replace the old public interest test.

Topic 4: What the position of the CC should be during the current crisis

36. **Christopher Clarke (CC Deputy Chairman)** predicted that the future may bring more market investigations in response to structural changes in the meantime. The CC would have to make decisions under much greater uncertainty than had been the case in the last 10 to 15 years, giving airports price reviews and the cost of capital as examples of judgement that would become much harder to make in the future, as these required some heroic assumptions about factors like oil prices, passenger numbers, and equity and debt markets. The next control period in the water industry would involve a capital expenditure programme in the region of £25 billion, for which Ofwat would have to decide not just on a cost of capital, but whether the programme was financeable. This would be demanding in the current climate. He concluded that the CC must make decisions against a background of substantially increased and very considerable uncertainty. This would be compounded by the possibility of an increase in appeals against regulators and against the CC.

37. There was general acceptance that the principles of sound competition policy and robust enforcement were as important now as ever. A number of speakers mentioned that the issues the CC was likely to face in cases would be different in the coming years. **Dr Mark Williams** made the point that cases would still be looked at on their merits, but there were likely to be, for example, more 'failing firm' defences, maybe involving merger to monopoly to avoid insolvency. The CC had had cases like this before and had adopted the hard line that the bankruptcy and reorganization process would reallocate the assets. Also he predicted that there might be more cases with markets with spare capacity or cases that looked like predations, which

were actually just survival strategies. In essence, he said that changes to the factual matrix did not mean that the fundamental policy framework should change.

38. **Dr Nicola Mazzarotto (CC Head of Policy Analysis)** agreed that the principles would be the same, but that these were unusual circumstances. Markets were likely to be fast changing, often declining, so analysis of the counterfactual would be important, eg in relation to 'failing firms'. There was a need to be aware of the specific features of declining markets, eg incentives for cartelization, opportunities for predation, not to be confused with survival strategies that might look like predation. It would be particularly important not to overlook efficiency claims. Entry claims, too, would need to be looked at carefully, in the context of a global recession. He called for a more joined-up approach between competition authorities and regulators, stating that competition authorities needed sector-specific knowledge. At the same time, he suggested that the CC could help the regulators where expertise about incentives and how competition shaped incentives could be useful to them.

39. **Rachel Merelie (CC Senior Inquiry Director)** spoke about how the CC might improve its efficiency and so reduce burdens on business. She outlined the pressures on the system: the OFT, for example, was under pressure to agree undertakings in lieu of reference and business claimed that there was a 'chilling effect' of the competition regime on mergers. On the market side, regulators could be reluctant to refer markets, as they were under pressure to deliver results quickly. Some pressures pointed towards longer inquiries: there was a trend towards more technical analysis and primary data and recent CAT judgments had reinforced the need for thorough and robust analysis. She said that the CC had already done a lot to streamline processes, with a focus on information gathering (including an increased use of section 109 notices) and analysis around the theories of harm, along with fewer and better-prepared meetings and hearings and less paperwork. The CC intended to move towards a standard 18-month timescale for market investigations rather than the statutory two years, but without cutting time spent on remedies. She noted that parties to the inquiries had a role to play here. There was a limit to how much faster the CC could move on mergers, as 24 weeks was quite tight for the amount of work that must be done.

40. **Diana Guy (CC Deputy Chairman)** spoke on remedies, beginning by pointing out that designing and implementing effective remedies were in some ways the most important parts of the CC's process. Identifying competition problems in markets or in relation to mergers was only a first step and unless we could find a way to remedy or mitigate the damage then our involvement would not have made any difference. She emphasized that the CC needed to devote adequate time and resources to getting remedies right, with the CAT's Tesco judgment underlining the need to spend more time on remedies.

41. She observed that structural remedies only worked if there was a buyer and in the current climate that might be difficult. She stressed that the basic principles and analysis did not need to change, but we needed to apply them with flexibility, for example in the BAA remedies there could be some flexibility in terms of timing. Parties in mergers, especially completed ones, needed to get the message that our basic approach would not change. They needed to be aware of the costs and risks of completing without prior clearance, including the risk of forced divestment, which in the current climate could mean a substantial loss. The CC needed to face up to the fact that it might not be able to find an acceptable buyer and so needed to have fallback behavioural remedies, as in Scottish Buses.

42. **Laura Carstensen** said that the CC needed to communicate its strengths more and guard its uniqueness as its fitness for purpose, costs and ways of doing things came

under scrutiny. She said that the CC needed to be more outward looking and engage with government departments to engage with issues before they got too far along for the CC to influence them.

43. **Professor Stephen Wilks (CC member)** made the point that the competition regime was facing challenges and would be up for reappraisal with an election soon and while there was satisfaction with how the regime had bedded down, there was still a need to project the virtues of the system effectively.

Summing up

44. **Peter Freeman (CC Chairman)** concluded the discussion. The Great Depression had lessons for us. At the time in the USA there was conflicting industrial and competition policy in relation to trading codes and practices and the cartels that these allowed for. Eventually, the relevant statute was struck down by the Supreme Court on the grounds that it gave the President too much power, with the Supreme Court saying memorably that ‘difficult times do not justify constitutional extension’. He quoted from an article John Harkrider had written in the most recent edition of the ABA bulletin: ‘the current economic crisis may provide evidence that markets are not inherently self-correcting, but it does not provide evidence that markets do not work’. That was the principle.

45. This was a serious economic situation that bore comparison with the Great Depression. We may feel ready to deal with it, but we should not underestimate its significance. We needed to recognize that it might lead to a debate about the structure of competition institutions and enforcement. ‘It is very easy in this great institution to be like theologians discussing aspects of doctrine while the church is burning down around our ears’. The message to take away was that there would be people questioning the right of competition authorities to exist, questioning the intellectual basis for competition, how it fitted in with the wider economy and whether the market economy was dead. We had important responsibilities as part of the competition ‘family’. The well-tried principle of competition needed to be talked up. We should play a part in competition advocacy, despite being a reference authority. The CC must try to be as agile as it could be within its timing and procedures, and be prepared to be flexible as long as it could still secure the right outcome.