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The Financial Crisis and Competition Policy: Some Economics

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It is a familiar pattern that when the going gets tough, some of the not-so-tough seek exemptions from competition law. But might they have a point, especially when they are banks in an unprecedented financial crisis? This note reviews some of the basic economics of the crisis before concluding that October's systemic bank rescue package is not unduly competition-threatening, whereas the waiver of merger policy for the Lloyds TSB acquisition of HBOS was probably a policy mistake.

I. THE CRISIS: WHAT WENT WRONG?

The background to the crisis was the vast expansion over the past decade of the balance sheets (assets and liabilities) of banks and other financial institutions relative to their own capital.¹ The expansion resulted from huge global imbalances—Asian saving and Western borrowing to spend—combined with a very benign macroeconomic environment of steady growth, low inflation, low (real and nominal) interest rates, and a relatively *laissez faire* stance of financial regulation in the principal marketplaces.

This whole system proved fragile once placed under stress by falls in the value of assets, notably housing loans after sub-prime mortgage defaults rose in the United States.

* All Souls College, Oxford. Note of remarks at the *Jevons Institute Forum on The Financial Crisis and its Implications for State Aid Policy and Competition Law*, UCL (December 9, 2008). Without implicating them in any way, I am very grateful to Mark Carney, Ian Forrester, Paul Seabright, Hyun Shin and others for thought-provoking exchanges on the topic.

¹ For an authoritative account and analysis of events up to late October, see the Bank of England's *Financial Stability Report* (October 28, 2008).

In a robust system, asset price declines and fluctuating default patterns are naturally absorbed as part of the continual re-pricing of risk in the light of unfolding events, and risk capital continues to flow smoothly to business and household investment. What started to happen in mid-2007, however, was a massively destabilizing chain of events.

At least for us in the United Kingdom, the queues of depositors wanting to pull money out of branches of Northern Rock² in September 2007 were the first striking manifestation of the crisis. But the run on the Rock is a misleading guide to what was going fundamentally. For a bank, Northern Rock was unusually reliant on short-term funding from institutional investors rather than depositor funding. Rather than its loan book going bad, it was the seizing up of that source of market funding that left Northern Rock not just illiquid, but high and dry. The run by depositors was a consequence, not the cause, of its woes. The trouble had started before, as illustrated by the events of August 9, 2007 when money market spreads jumped, reflecting a sharply heightened perception of credit risks across the system, and central banks injected large amounts of liquidity. As Paul Seabright has put it, "the bubble burst because banks stopped trusting each other before the rest of us stopped trusting banks." Northern Rock was caught up in systemic deleveraging as market players of all sorts sought to shrink their balance sheet exposures.

This process gathered pace through 2008, with the Bear Stearns crisis in March, the Lehman Brothers bust on September 15, and then market turmoil that for a while threatened the whole financial (including payments) system. The vicious cycle of asset price declines and frantic deleveraging was in full swing, with major damage to the real

² See Hyun Song Shin, *Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis*, working paper, Princeton University.

economy and the conversion of a private debt crisis into a public debt crisis that will be with us for a long time.

II. POLICY RESPONSES

Policy responses have taken various forms, including:

- further vast injections of central bank liquidity
- extensions of bank deposit guarantees to stave off bank runs by depositors
- temporary bans on short selling
- the U.S. troubled assets relief program
- large-scale state ownership of banks and other financial institutions
- sharp cuts in official interest rates
- bypassing competition law to allow competition-threatening bank mergers.

Thus on September 18 came the announcement of the Lloyds TSB takeover of HBOS. On the same day, the Secretary of State for Business, Enterprise and Regulatory Reform announced his intention to issue an intervention notice to clear the proposed merger on public interest grounds to ensure the stability of the U.K. financial system. Not until October 24, however, did financial stability become a public interest consideration in U.K. merger law. By then, much else had happened.

Of particular importance was the announcement on October 8 of the package of *systemic* support for the U.K. banks and building societies. At the heart of this package are measures to boost bank capital, with the Government willing to subscribe capital in the form of preference shares yielding 12 per cent or ordinary share capital, subject to

conditions on dividend policy, executive pay, and lending to small businesses and home buyers. Banks joining the recapitalization scheme can also have the Government guarantee, for a fee and up to limits, new debt issuance. The Bank of England's short-term liquidity scheme was at the same time extended.

So whereas the September 18 announcement aimed to tackle the HBOS problem, the October 8 package addressed a systemic problem. Appraisal of this pair of measures depends on what the underlying problem really was (and is).

III. SOME ECONOMICS OF CONFIDENCE AND OF CONTAGION

The textbook problem with banks is one of confidence. Banks borrow short and lend long. That is to say, they take deposits and/or borrow from financial markets in a way that entitles the depositor or financier to pull their money out at short notice, while lending it to businesses, home-buyers and others long-term. There is nothing wicked about this—to the contrary, it is a highly efficient form of economic and social organization—but it is vulnerable to panic attack. More prosaically, there are two equilibria: one good, one bad.

At the good confident equilibrium, depositors/financiers are happy to keep their money in the bank until they need it, and the investments financed by those deposits reach profitable maturity. At the bad bank-run equilibrium, depositors/financiers worry that others will pull their money out, thereby causing the plug to be pulled on investments prematurely, so everyone runs to pull their money out. Even if the underlying assets of the bank—i.e. the loans to businesses, homebuyers, and so on—are perfectly sound, there

is vulnerability to bank runs. Then there is a *liquidity* problem even though there is no *solvency* problem. Since at least Walter Bagehot wrote on these issues in the 19th century, the classic solution to such a problem is liberal central bank liquidity (albeit at a penal rate) to stop the plug being pulled on the investments. Indeed, the knowledge that the central bank stands ready to be lender-of-last-resort helps avoid the problem in the first place, as do deposit guarantees (if credible).

In these terms one can think of *confidence* as the set of beliefs that keeps everyone at the good equilibrium. A crisis of confidence occurs when behavior threatens to shift to the bad equilibrium. HBOS clearly had a confidence problem in the first part of September. If the Lloyds TSB takeover would do the trick—the confidence trick so to say—of shifting beliefs to the good equilibrium in relation to the HBOS balance sheet, then there would be a reasonable case to entertain the bypassing of normal merger control. Indeed a highly tempting case.

The trouble with the argument is that it works cleanly only if the problem is "just" a confidence problem affecting the weaker bank (i.e. HBOS). What became apparent between September 18 and October 8 was that the problem was far bigger. It was systemic and it was about insolvency as well as liquidity. The restoration of optimistic beliefs was not going to be enough. The fundamentals needed radical repair. The ratio of bank balance sheets to bank capital had been way too high. The deleveraging spiral was contracting balance sheets in a highly disorderly fashion. Major injections of capital were needed at the base. The October 8 plan reflected this diagnosis.

The problem was moreover one involving deep and international interdependences among financial institutions. As the case of Lehman illustrated sharply, one major bank going down threatened others—again not just by "confidence" effects but by the potentially cascading effects of balance sheet contagion from the spiral of deleveraging and asset price decline, coupled with heightened counterparty risks.

IV. THE SUPPORT SCHEME MAKES ECONOMIC SENSE AND IS NOT IN TENSION WITH COMPETITION PRINCIPLES

Given that the crisis is systemic and one of inadequate capital, not just insufficient liquidity, schemes on the lines of the U.K. plan announced of October 8 make good economic sense. While state bailouts of arguably insolvent institutions are deeply unattractive, the realistic alternatives were still worse. The scheme is broadly competitively-neutral among U.K. institutions, and positive for other countries, many of whom have emulated the package. So while it is surely state aid, it is not seriously competition-distorting aid. Thus the European Commission

found the measures to be compatible with EU state aid rules, because they were an appropriate means to remedy a serious disturbance in the UK economy ... while avoiding unnecessary distortions of competition. In particular, the package provides for non-discriminatory access, is limited in time and scope and contains safeguards to avoid the abuse of the scheme.³

In short, the package is not in tension with basic competition principles.

³ Commission Press Release IP/08/1496, Brussels, 13 October 2008.

V. THE MERGER CONTROL WAIVER FOR LLOYDS TSB/HBOS IS ANOTHER MATTER

Alas the same cannot be said for the lifting of normal merger control for the Lloyds TSB takeover of HBOS. As indicated above, that might have been a good move if it had solved a mere confidence problem—indeed its prospect may in fact have helped confidence for a week or two—but it does very little for a problem of systemic under-capitalization.

On the same day that financial stability became a public interest consideration in U.K. merger law, thereby allowing Ministers lawfully to over-ride a merger reference by the Office of Fair Trading ("OFT") to the Competition Commission, the OFT published its competition assessment of the proposed takeover.⁴ The OFT concluded that there is a realistic prospect of a substantial lessening of competition in personal current accounts and in banking services to small and medium sized enterprises, especially in Scotland, relative to both the short-term situation of HBOS continuing with Government support, and the medium- to long-term situation where HBOS is again independent or sold to a third party that does not raise competition concerns. In addition, the OFT found competition concerns in relation to mortgages in the medium- to long-term.

On October 31 the new Secretary of State cleared the merger without reference to the Competition Commission. The Merger Action Group—an association of persons and

⁴ *Anticipated acquisition by Lloyds TSB plc of HBOS plc*, OFT, (October 24, 2008).

businesses in Scotland— appealed to the Competition Appeal Tribunal to quash that decision on the grounds *inter alia* that Secretary of State:

- had his discretion unlawfully fettered by September 18 statements by senior ministers that the merger would be cleared under a public interest criterion not then in law, and
- acted irrationally and without proper regard to relevant considerations in clearing the merger on the basis of the changed circumstances of late October.

In its judgment⁵ given on December 10, the Tribunal dismissed the appeal, finding no basis for the allegation that the Secretary of State had not given proper consideration to the continuing need for the merger.

Though it was not found to be in breach of the applicable administrative law standard, I do believe (at any rate on the basis of what is in the public domain) that, once the October systemic support plan was in place, the decision was a mistake in economic terms. It has potentially high costs in terms of a serious risk of an irreversibly less-competitive banking services market in Great Britain, especially in Scotland, for the long term. If these costs do materialize, they will, however, be borne by future consumers, not current political decision-makers.

VI. COMPETITION POLICY IN AN ECONOMIC RECESSION

As to the short-term political consideration just mentioned, the incentive and opportunity for vested interests to seek favors from the political system are greater than usual in an economic recession. But that is not because macroeconomic policy goals and

⁵ *Merger Action Group v Secretary of State for Business, Enterprise and Regulatory Reform*, [2008] CAT 36.

competition are in conflict. Indeed, firms with market power have incentives to restrict output and employment relative to those that face competition. It remains to be seen whether governments and legislators have the resolve to resist the vested interests, but they would do well to remember that competition policy, like a puppy, is not just for Christmas.