The specificity of financial markets

Financial instruments that are traded on financial markets differ from ordinary goods and services in a number of dimensions. They represent claims on uncertain future streams of income, whereas goods provide either instant services or future but relatively certain streams of services (in the case of durable goods). The prices of financial instruments are often more volatile, due to their sensitivity to changes in the expectations of the uncertain income stream. The role played by expectations in the pricing of claims on future streams of income also makes financial markets more prone to the development of bubbles. Financial market bubbles may arise when market expectations — the anticipation that a future stream of income will increase — lead to an immediate increase in the price of the asset, which may reinforce market expectations that the underlying stream of income will further increase in value.

Notwithstanding the above, the specificities of financial markets from a public policy perspective arise to a large extent from the special characteristics of financial intermediaries and in particular banks. So how do banks differ from other companies?

Instability of banks

First, banks differ from ordinary firms because their role in the transformation of maturity exposes them to relatively high risks of illiquidity. Banks pool and transform short-term funds into long-term investments. Liquidity risks materialise when a sudden surge in withdrawals precipitates a forced liquidation of assets at substantial discounts. As a result banks may be unable to meet all withdrawals and become insolvent. However, the anticipation that some creditors will withdraw funds will give others the incentive to withdraw themselves in order to avoid being exposed to an insolvent debtor. This in turn validates the expectation that withdrawals will occur. In other words, banks are subject to runs on deposits associated with self-fulfilling expectations that withdrawals will take place. The occurrence of runs can be thought of as a market (coordination) failure which can be addressed by government intervention in the form of liquidity assistance by central banks and deposit insurance protection. However, deposit insurance leads to a problem of moral hazard, as the owners and managers of banks do not bear the full consequences of unfavourable realisations of their investments and are thus induced to take excessive risks. The incentive of depositors and creditors to monitor the banks is also reduced.

Second, banks differ from ordinary firms in terms of their risk exposure. Their main activity on the assets side involves the purchase of claims on uncertain future cash flows, and they finance these purchases through a limited amount of equity supplemented by funds provided by creditors. Given their relatively high leverage and creditor dispersion (which leads to imperfect market monitoring), the usual problem of moral hazard stemming from limited liability plays a particularly important role in banking. In other words, the management and the shareholders of banks may have an incentive to take on excessive risk on the asset side or at least remain silent about the riskiness of the pursued strategy.

Third, banks differ from ordinary firms by the extent to which they can quickly expand (and contract) their balance sheet and hence the volume of their business. Expansion which merely involves entering into new financial contracts (on both assets and liability sides) does not require extensive investments and lead times. Expansion which involves the accumulation of relationship capital on the asset and deposit side might take longer. In any event, banking activities are more divisible than others. Even when it involves relationship capital, it is embodied in employees and this capital is thus easily identifiable and spun off.

External effects and amplifying dynamics

As a result of these features, markets in which banks operate are subject to significant systemic risks of instability. This is due to the negative externalities that a bank failure (or the anticipation of it) generates on its competitors. While the failure of a company nor-

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(1) This is a shortened version of the European Commission note to the OECD round table Principles — Financial Sector Conditions and Competition Policy. The full version of this contribution — by Stan Maes from the Chief Economist Team — may be found at http://ec.europa.eu/competition/international/multilateral/2009_feb_roundtable1.pdf

(2) Note that banks are not vulnerable to runs because of excessive competition. A run can even take place on a monopolist bank.
mally tends to favour its competitors and potentially even strengthens the economy as a whole by removing an inefficient player, a bank failure may weaken its competitors and negatively affects the financial markets in which they interact.

The negative externalities of a bank failure (or the anticipation of it) arise through various channels. First, as banks have extensive exposures to one another, losses of one bank will be borne by other banks (in case of failure or through a reduction in the value of their debt). The position of these banks may in turn be weakened and entail losses for their own creditor banks. Losses can spread directly through interbank exposures or indirectly through guarantees, credit lines, or insurance against credit risks (credit default swaps or CDS) that are being drawn and called. Second, pure informational contagion can arise such that the failure of one bank leads to an adjustment in the expectations regarding the viability of other banks perceived to be “similar” (even in a simplistic sense).

The development of negative externalities across banks is also subject to amplifying dynamics. What can initially appear to be exogenous risk triggers some reaction among banks which generates endogenous risk. To illustrate, following the realisation of losses on its assets, a bank may attempt to reduce its leverage (and indeed will often be compelled to do so by capital regulation). It will thus sell securities, which might trigger a fall in price of these securities, thereby inflicting a new round of losses on the securities portfolios of other banks, which generates the need to deleverage further. Alternatively, the bank can reduce its leverage by restricting its credit to the real economy, which increases the probability of default of all other borrowers in the economy, again inflicting a new round of losses on their credit portfolio and a similar downward spiral.

The need for ex ante and ex post regulation

Overall, the social costs of a bank failure (or the anticipation of it) exceed the private costs by far. This underlies the need for government intervention both ex ante and ex post (in times of crisis). There is extensive ex ante financial regulation (capital adequacy regulation, licensing requirements, deposit insurance, bank supervision, etc.) as well as ex post intervention and it is in the latter that competition enforcement has an important role to play.

It is beyond the scope of this article to comment extensively on the origin of the current financial crisis and the design of ex ante regulation. It would appear, however, that inadequate policies have contributed to the current crisis and its magnitude, given that the aggregate exposure to subprime loans which has triggered the crisis is relatively small compared to the pervasive repercussions it has triggered. In light of the heavy regulation that applies to banks and their role in the monetary system, the main causes of the crisis indeed seem to be monetary policy (which, with the benefit of hindsight, was far too lax, leading to the creation of major asset price bubbles), flaws in the regulatory design (that have set the wrong incentives and allowed loopholes to be exploited), and inadequate supervision (allowing the shadow banking sector to grow out of control and excess confidence that a securitised market-based financial sector would be more resilient to shocks than a bank-based financial sector).

Competition policy in the financial sector

In principle, the degree of competition might affect the probability that a financial crisis develops through two channels. First, competition affects the value of bank franchises. Faced with difficulties, banks might, in the presence of imperfect monitoring by the regulators and the markets, face the choice of either strengthening their capital base or further enhancing risk taking, hoping that positive outcomes will materialise (this is commonly referred to as “gambling for resurrection”). The relative attractiveness of these options depends on the regulatory framework and the scope for moral hazard (i.e. the extent to which shareholders and managers will lose in the event of failure) but also on the value of bank franchises (which would be lost in case of failures). The value of the bank franchise can be seen as the present value of the rents that can accrue from pursuing banking activities and is partly determined by competition. Intensive rivalry might reduce the number of bank franchises and increase the likelihood that, faced with a shock, banks will choose to gamble for resurrection. Serious doubts can be cast on the relevance of this effect in the context of the current crisis as the return on equity in banking was high in the years preceding the crisis, both in absolute terms and on a risk-adjusted basis. And indeed, to the best of our knowledge, neither banks nor regulators have suggested that rents in banking were insufficient in the context of the public policy debate surrounding the financial crisis.

Second, when faced with insufficient prudential regulation, competition between banks may put pressure on prudent banks even if they do not face immediate difficulties. If some of their competitors take excessive risks to generate high current profits, prudent banks may be tempted to gamble in order to maintain their ability to attract funds. But also for this second potential impact of competition on risk-taking, competition policy is the wrong instrument. First, even very lax competition policy (e.g. inactive
merger control) is unlikely to eradicate the problem due to the existence of residual competition in global markets. Second, inactive competition policy would bring about unwanted side-effects. Besides the usual monopoly distortions, this policy would also create a banking landscape where “too big to fail” is the norm, thereby exacerbating the problem rather than addressing it. Therefore, if there is recognition that prudential regulation is not strict enough to prevent excessive risk-taking, the logical consequence is not to use competition policy to remedy this, but to adapt prudential regulation itself. This allows the root of the problem to be addressed without being exposed to the detrimental side-effects of indirect regulation via competition authorities. In short, while situations are conceivable where competition may increase risk-taking among banks, lax competition policy would more likely exacerbate than solve the problem.

The role of State aid control on the ex post regulatory response

As indicated earlier, competition policy and enforcement have an important role to play in the ex post regulatory response. The public policy challenge in response to the development of a financial crisis is to maintain financial stability while preserving incentives for appropriate risk taking and competition in the future.

EU State aid control is particularly relevant when distortions of competition arise across Member States. Its main objective is thus to establish rules allowing States to intervene in the presence of market failures while avoiding distortions of competition by maintaining the level playing field for undertakings operating in the EU. EU State aid control is thus characterised by a high degree of transparency, supporting the establishment of a level playing field in the common market.

The main issue of incentives arises in terms of moral hazard for the recipient of support. The rescue of banks (or more generally support for banks in difficulty) might have the effect of protecting the providers of funds (owners and creditors) and the bank managers from the consequences of past (excessive) risk taking. The rescue measures might strengthen the expectation that insurance will be provided in future cases of distress and create renewed incentives for excessive risk taking. Measures aimed at financial stability should thus be designed so as to mitigate problems of moral hazard. The rescue (or support given to banks in difficulty) also affects competitors directly and distorts their own incentives to compete. If banks that have not indulged in excessive risk taking observe that their competitors are bailed out, incentives for appropriate risk taking will be further impaired.

Distortions of competition associated with moral hazard and the consequences of rescues for competitors can be addressed by mandatory financial and corporate restructuring of banks. Financial restructuring in particular can ensure that incumbent owners, creditors and managers are not subsidised (given their institutional responsibility for the decisions leading to distress). State aid control has an important role to play in this respect.

One of the root causes of the current turmoil is indeed moral hazard: numerous financial institutions (FIs) have become too big to fail (TBTF) or too interconnected to fail (TITF). This of course means that banks have a strong incentive to become TBTF/TITF, as they will benefit from an implicit free insolvency insurance. Banks do not only want to become big, but they can and do effectively expand (and shrink) their balance sheets much more easily than ordinary firms, because their assets and liabilities are mostly intangible and because their regulatory leverage limitations are imposed based on the amount of risk-weighted assets (implying that additional individually risk-free assets can be piled on without constraining the bank).

Many FIs are TBTF and therefore require public support in the current crisis, as the social costs of failure would greatly exceed the private costs to shareholders and creditors. While accepting the need for intervention, it is important to ensure that flawed business models are not rewarded for their failure and that expectations that financial institutions are TBTF, and will therefore be bailed out, are not reinforced.

This can be achieved through the design of the mandatory restructuring plans that banks that are not fundamentally sound have to elaborate. Restructuring plans are part of the obligations imposed on FIs that are not fundamentally sound for receiving public support. Three central pillars of these plans are the private contribution to the coverage of restructuring costs (aid kept to the minimum), compensatory measures, and long-term viability. The first requirement ensures that the restructuring costs are borne by the owners, creditors, and managers of the entity receiving support, to the extent possible. The second is aimed at reducing the competition distortion. The third pillar seeks to ensure that state intervention has a lasting positive effect on the aided firm and the sector in which it operates. Return to viability should also ensure that the firm will not require additional State support in the future. It should be stressed that orderly liquidation may eventually constitute a realistic alternative to restructuring.
By contrast, fundamentally sound banks that become distressed through contagion (i.e. through the development of systemic effects) in principle do not require mandatory financial and corporate restructuring, given the absence of a clear moral hazard problem.

The implementation of financial and corporate restructuring may have to be tailored to the specificities of the financial industry. For non-financial firms, competitors are normally hurt by the rescue, as they would otherwise have faced less competition. Compensatory measures involving asset disposals and/or capacity reductions can then reduce the extent of the distortion of competition imposed on competitors. For FIs, the rescue might actually benefit competitors because of systemic linkages. Indeed, the experience of Lehman Brothers has shown that the uncontrolled disappearance of players with a flawed business model may effectively hurt the remaining banks. The importance of inter-bank lending means that banks are each others’ creditors and the failure of one bank will therefore hurt other banks as creditors. The disorderly unwinding of a systemically relevant bank may also affect the pricing of some assets that have to be sold abruptly, and with consequential high losses, potentially also depressing market prices. Finally, a bank failure may hurt investors’ and depositors’ trust in the financial system, which is paramount to the efficiency of financial markets. For that reason, bank rescue may need to be authorised very swiftly to avoid serious disturbance in the economy.

However, as in other sectors, the need to contain moral hazard and to preserve effective competition requires that rescued banks provide restructuring plans in order to: (i) restore long-term viability, (ii) limit State aid to the minimum necessary and (iii) introduce compensatory measures limiting the distortion resulting from failing banks being still in business and taking away market shares from sound competitors. In the case of fundamentally sound banks, there may be less of a need to consider compensating measures. The fact that banks may remain TBTF is still a source of concern. In this respect, there are complementarities between competition enforcement and regulation (for instance, capital requirements proportional to the systemic incidence of individual banks) that should be exploited.

The (non-)alternative of relaxing merger control

Relaxing merger control might be considered as an alternative to state aid support for banks in distress. There are at least four reasons that discredit this idea.

First, it may not work. Whereas State aid provides immediate support, monopoly rents might take time to materialise. Net benefits for the merged entity are also uncertain. If cost for the consumers can be anticipated, past experience clearly indicates that the merger of two distressed institutions does not create a sound efficient one. In addition, empirical studies of banking indicate that minimum efficient size is reached quickly. Given the size of most FIs, and in particular the distressed ones, merger would not deliver the gains derived from economies of scale, as the latter have been exhausted. One should be equally sceptical about the potential benefit from exhausting economies of scope. The current turmoil is partly due to the fact that Chinese walls to keep distinct activities clearly separate have shown to be ineffective, leading to lack of transparency, agency problems, and conflicts of interests. Thus, in appraising mergers, it should be borne in mind that Chinese walls are either ineffective, or, if they can be effective, then there is no room for scope economies. A merger cannot therefore be defended by a combination of Chinese walls (for prudential purposes) and efficiency claims based on economies of scope.

Second, the duration of the stream of monopoly rents that would accrue from allowing an anti-competitive merger is potentially unlimited. By contrast, State support can be designed to be temporary and non-recurrent (with the limits of governments’ ability to commit). It can also be tailored to the specific problems of the bank in distress. Third, lax merger control would plough the seeds for future systemic crises by contributing to the creation of FIs that are TBTF or TITF.

Finally, while State aid can be made contingent on financial and corporate restructuring, lax merger control is a licence to extract monopoly rents without condition. Rewarding mismanagement by the right to exercise market power would compound problems of moral hazard.

State aid and crisis resolution

The banking crisis in Europe is without historical precedent. Obviously links can and are being made to the 1933 Great Depression and the 1997-1998 crisis in Japan, but what really sets Europe apart from these episodes is that Europe’s response is driven by national initiatives without a unique pan-European supervisory, regulatory, and legal framework. As a result of this and as a result of the differences in fiscal capabilities across Member States, the crisis management and crisis resolution mechanisms that are being implemented differ to a certain extent, opening the door to competition distortions and unlevel playing fields.

A particular source of concern is the lack of a pan-European special resolution regime for banks that would allow prompt corrective action by the supervisor before technical insolvency was reached. Such
a regime would allow the bank to stay in business during the restructuring phase, and would allow a swift and orderly liquidation if the bank is no longer viable. In the absence of such a supra-national regime, EU State aid policy, and more particularly the Commission’s rescue and restructuring guidelines and procedures, have provided and should continue to provide a robust and flexible framework enabling the EU and its Member States to take effective measures to combat the crisis in the financial markets and in the real economy, while at the same time minimising the distortive effects on competition and on the level playing field.