DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

COMPETITION AND FINANCIAL MARKETS

-- Volume 2 --
FOREWORD

This document comprises proceedings in the original languages of four Roundtables on Competition and Financial Markets held by the Competition Committee in February 2009.

It is published under the responsibility of the Secretary General of the OECD to bring information on this topic to the attention of a wider audience.

This compilation is one of a series of publications entitled "Competition Policy Roundtables".

PRÉFACE

Ce document rassemble la documentation dans la langue d'origine dans laquelle elle a été soumise, relative à quatre tables rondes sur la concurrence et les marchés financiers qui se sont tenues en février 2009 dans le cadre du Comité de la concurrence.

Il est publié sous la responsabilité du Secrétaire général de l'OCDE, afin de porter à la connaissance d'un large public les éléments d'information qui ont été réunis à cette occasion.

Cette compilation fait partie de la série intitulée "Les tables rondes sur la politique de la concurrence".

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1. Roundtable 1 on Principles: financial sector conditions and competition policy

Questions of interest include:

1.1 How are financial markets distinct from other types of markets? In what ways might competition policy treat financial institution and products differently as a result of these differences?

The fundamental difference from a regulatory perspective between financial markets and other markets is in our opinion concerned with the extent to which financial markets and operators depend on the public confidence and the confidence of financial institutions in each other.

In case a regulator or supervisor (hereafter regulator) sees any anomaly and does not receive a satisfactory response from the undertakings concerned, a public warning or sanction are only options provided the financial institution concerned is too small for a loss of confidence in that institution to have a significant impact on the confidence in the financial system. When a regulator raises serious issues with a major operator, and the operator does not cooperate, it will often be difficult to issue a warning against the operator’s practice without jeopardizing the confidence in that financial institution. And a loss of confidence in one major financial institution can easily snowball into a loss of confidence in the market. By using the traditional techniques for sector regulation, the regulator thus risks to contribute to the realization of the risks he wishes to avoid. With regard to the regulation and supervision of financial markets, the traditional regulatory toolbox will often be inadequate, because transparency and adequate information of the public risks to turn an operator issue into a systemic crisis. The financial crisis has therefore confronted us, not only with the limits of self regulation, but also with the limits of what government regulation can achieve, regardless whether the supervision is exercised on a European or a national level.

It seems therefore advisable:

- that regulators of financial markets do institutions can not only use the traditional supervision instruments such as warnings and reports, but can also exercise some other forms of discrete pressure. This will require a delicate balancing between the need for an adequate regulation of financial markets, and the general principle that regulators may only use the information received as a supervisor for the purpose of their supervisory powers.

- to envisage a renewed focus on product regulation alongside operator regulation and supervision. We do not suggest that financial markets can be limited to trade in regulated products, but we suggest examining a ‘quality label approach’ or a distinction between regulated and non-regulated products.

This key issue for banking regulation does not have necessarily a significant impact on the enforcement of competition rules in respect of restrictive practices. We think that it is, in normal times, unlikely that the general public, other financial institutions and the business community will lose confidence in a financial institution because it might be involved in a competition law infringement case.
Only when the financial situation of these institutions is already known to be fragile, there is reason for special restraint when envisaging procedures that may imply a risk of very high fines.

With regard to the specificities of financial markets in respect of merger control, we refer to our comments for the 2nd Roundtable.

1.2 What failures of competition may have contributed to the crisis in the financial sector?

We do not think that a failure of competition has contributed significantly to the crisis in the financial sector. We see mainly four (related) causes of the crisis:

- Financial institutions were assessed according to their ratings. The rating institutions rated financial institution *inter alia* on the basis of the rating of their assets. We understand now that rating companies all too often rated assets on the basis of the rating of issuers and traders, rather than on the basis of a proper assessment of the risks related to their components. This was a circular argument that made that the lack of transparency of structured products remained unchecked, and that the confidence in financial institutions was not based on a proper risk assessment.

- While structured products can be a useful instrument if the percentage of bad debt is limited, the unlimited repackaging of bad debt made possible by the way financial institutions and products have been assessed, is not only a major cause of, but also a major obstacle to manage the crisis.

- Models of remuneration that did not take into account the long term corporate interest and sustainability, and mainly focused on short term shareholder value.

- Customers were all too easily attracted by offers that looked tempting compared to the products that were available before the opening of markets for financial products and services. They neither gave sufficient attention to the warnings in the regulated information (this problem was even worse at the time of the internet and high tech bubble), nor wondered about the credibility of operators they had never heard about. The internet culture has clearly eroded the risk awareness of significant groups of customers.

1.3 What has been the role of competition in credit rating services, and of barriers to entry into providing those services?

We think that the rating services bear a heavy responsibility for the crisis. We have, however, no indications that competition between rating services was as such a contributing factor. If competition helps to explain their behaviour, this is due to a common disregard for the sustainability of developments and lack of sense of responsibility for the consequences of their actions v. short term profitability.

We assume that the barriers to entry for rating companies have been high because of the need to build up know how and credibility. We wonder to what extent that is still the case after the loss of credibility of the existing rating companies.

2. Roundtable 2 on Crisis: Role of competition policy in financial sector rescue and restructuring

Questions of interest include:
2.1 Should competition law be set aside in the financial sector during a systemic crisis, on public interest or other grounds? If so, how should this be done?

Competition law should not be set aside. At least in the EU and Belgian contexts, the authorities are well equipped to take into account the economic circumstances when modulating the enforcement of the rules of competition.

2.2 How should competition agencies apply general competition policy rules about mergers, anticompetitive conduct and state aid during a crisis? Is it practicable to apply failing firm doctrines to mergers as crisis actions? Is the consideration required for merger review of the financial sector during a crisis different from that required for merger review of other sectors? How should negative competitive impact on the market structure in the medium and long term be assessed in reviewing mergers required to sustain the financial system?

The Belgian Competition Authority is unlikely to be a first line actor in significant crisis-related mergers in the financial sector. Such transactions are likely to have a Community dimension in the meaning of Regulation 139/2004 (the EU merger regulation).

The failing firm doctrine can help to offer an adequate response. More generally, the economic impact of transactions should be examined in the light of what can reasonably be expected to be a sustainable development of the market structure.

We consider moreover that mergers in the financial sector in times of crisis should not only be assessed in the light of their impact on the structure of relevant markets. Given the network of state guarantees and consumer protection schemes, they should also be assessed in the light of the probability that they will help to avoid bankruptcies and of the impact bankruptcies of financial institutions have on public finance and on other financial institutions. The negative impact on the economic environment for enterprises of a significant worsening of public finance is likely to be more significant than any positive impact merger control might have. And while bankruptcies outside the financial sector can benefit to competitors, the bankruptcy of a financial institution may seriously damage banks that are at the same time competitors and business partners in the inter-banking market.

3. Roundtable 3 on Real economy: Challenges for competition policy in periods of retrenchment

Questions of interest include:

3.1 How should competition rules apply to acquisitions of failing firms or firms in distress, in current financial market conditions? How should negative competitive impact on the market structure in the medium and long term be assessed in reviewing mergers or state aid?

Given the fundamentally different impact of bankruptcies, we suggest to apply the failing firm doctrine to mergers outside the financial sector with more restraint than to mergers involving financial institutions.

Mergers involving failing firms outside the financial sector should inter alia be assessed in the light of the extent to which the problems of the failing firm are related to the present economic crisis and the sustainability of the proposed business plan in the medium term.
3.2 Will tightening financial markets create barriers to entry and expansion in the real economy? If so, how should competition enforcement respond?

The impact of the financial crisis on the so-called real economy (we wonder whether this terminology is still appropriate in a post-industrial society) is one of our three major concerns (together with the impact on the financial sector itself and on public finance). We have no jurisdiction in respect of state aid, but we can see a case for state intervention to the extent that it only compensates for the lack of availability of bank financing that would have been available in normal circumstances.

3.3 How should competition policy respond to proposals for modern versions of “depression” or “rationalization cartels” and similar schemes? What lessons can be drawn from previous crisis-driven policies to reduce competition, such as the self-regulation that was encouraged during the depression of the 1930s?

It is until now our policy to have a more positive attitude towards optional cooperation schemes (e.g. joint selling as well as joint purchasing arrangements) if they allow SMEs to remain present on markets with major players, but we continue to be strict in respect of horizontal production quotas.

3.4 Is it necessary to consider the risk of harming long-term economic development by revitalizing failing firms or firms in distress via protective measures by the government and consequently putting other healthier firms at a disadvantage in their terms for competition?

Yes indeed.

4. Roundtable 5 on Going forward: Adaptation of competition rules, processes and institutions to current financial sector issues

Questions of interest include:

4.1 Should competition authorities extend the conception of consumer welfare to include macroeconomic benefits from ensuring system stability?

The consumer welfare concept should embrace the medium to long term dimension and therefore not make abstraction of the macroeconomic benefits of system stability.

4.2 On the relationship between financial sector regulators and competition authorities:

4.2.1 How does the role of competition agencies interact with the role and remit of authorities and regulators responsible for financial services, securities and commodities exchanges, monetary policy, financial stability and accounting standards? What should be the respective responsibilities and scope of coordination between competition agencies and these regulators? Should competition agencies develop in-house expertise about financial markets?

Competition authorities should have jurisdiction for the enforcement of the rules of competition in all sectors of the economy.

They therefore need to have some in-house expertise about financial markets or the ability to acquire such knowledge at short order.

There is moreover a good case for measures or mechanisms for the coordination of interventions by the competition authority and by sector regulators in case the sector regulators can take decisions that may jeopardise the efficiency of competition law enforcement. This risk varies significantly from sector to
sector but seems to be low in respect of financial markets regulators given the specificity of market access and supervision criteria used in the regulation of financial markets. The risk is e.g. higher in respect of telecom and postal market regulators because the relevant sector regulations provide for the definition of relevant markets, the assessment of market power and the degree of competition.

4.2.2 What are the legal and practical impediments to competition agencies and financial sector regulators sharing information and market analysis and working together to formulate policy initiatives and interventions? How best can competition agencies engage in coordinated competition advocacy?

Confidentiality rules. The competition rules and the sector regulations should provide for a (limited) exchange of information between the various authorities.

Competition authorities and financial markets regulators should be informed of each others priorities, but we see no need for specific coordination of or for joint advocacy policies.
CHALLENGES FOR COMPETITION POLICY IN PERIODS OF RETRENCHMENT

CANADA

A variety of indicators suggest that Canada is well-positioned to weather the current economic crisis. In particular, recent reports have underscored the soundness and sophistication of Canada’s economy, which has exhibited a certain degree of stability relative to other jurisdictions. However, the scope and complexity of the crisis have yet to be fully understood by the global community, and governments and businesses now face mounting pressures to respond.

In this regard, chief among the challenges faced by national competition authorities (“NCAs”) is effectively advocating the continued application of pro-market competition policies to assist in economic recovery efforts in the short and, in particular, long term. But the crisis also challenges NCAs to consider how they might align existing organizational processes to better account for prevailing economic conditions, including by seeking out procedural efficiencies, and by establishing greater coordination with NCAs in other jurisdictions, particularly in the context of analyses of claims by so-called “failing firms”.

1. Continuing Application of Competition Policy

As a general principle, incentives to engage in anti-competitive conduct are amplified during an economic downturn, as competitors seek to sustain profitability and maintain market share by engaging in, for example, bid-rigging, abuse of dominance, and conspiracies to fix prices, allocate markets and restrict output. Although relaxing competition laws or allowing enforcement exceptions, such as “crisis cartels”, may have the short-term effect of assuaging sectoral interests, the harm to the market can be both extensive and enduring. Among other effects, even after a crisis has passed, connections forged among firms during limited periods of authorized collusive activity can be difficult to sever.

In the opinion of the Canadian Competition Bureau (the “Bureau”), continuing efforts to minimize the effects of the economic crisis should be premised on consistent, rigorous enforcement of pro-market competition policies. Canada’s Competition Act\(^1\) is, with certain limited exceptions, a law of general application, capable of accommodating both ordinary and extraordinary market conditions. Accordingly, just as the Competition Act applies during times of prosperity to prevent conduct that deprives markets of the innovation, efficiency and productivity that would otherwise be present, it is of equal, or greater, importance during times of economic hardship.

However, given that the benefits of competition can be difficult to quantify, and are often intangible, attracting and retaining support for pro-market competition policies will depend, in part, on the ability of NCAs to convey the nature of these benefits to the broader public, including industry participants who would otherwise seek to oppose such an approach.

In the view of the Bureau, NCAs can to some extent meet this challenge by echoing one another in emphasizing in actions and statements that enforcement activities will not abate during the crisis. At the same time, NCAs can demonstrate a clear sensitivity to present economic conditions by seeking to improve

\(^1\) R.S.C. 1985, c. C-34.
internal procedures and by bolstering efforts to coordinate operations with other NCAs, specifically with respect to claims by so-called “failing firms”.

2. Failing Firm Claims: Internal Efficiencies and International Coordination

Given the severity of the economic crisis, it is not unreasonable to expect an increase in the number of mergers involving firms in financial distress. The financial viability of a firm (the “failing firm factor”) is one of a number of factors enumerated in section 93 of Canada’s *Competition Act* that are considered in the analysis of a merger’s competitive effects. In particular, subsection 93(b) states:

In determining, for the purposes of section 92, whether or not a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially, the Tribunal may have regard to the following factors:

…

(b) whether the business, or a part of the business, of a party to the merger or proposed merger has failed or is likely to fail.

The Bureau’s interpretation of this failing firm factor is found in its *Merger Enforcement Guidelines* (the “MEGs”). The MEGs recognize, among other things, that the loss of the actual or future competitive influence of a failing firm should not be attributed to a proposed merger involving that firm if imminent failure is probable and, in the absence of a merger, the assets of the firm would be likely to exit the relevant market.

The MEGs apply an insolvency test to identify a failing firm, relying upon documents submitted by the firm, such as the most recent audited financial statements and projected cash flows, that are then typically reviewed by financial experts retained by the Bureau. In addition to assessing the firm’s financial circumstances, the Bureau will consider whether alternatives exist to the proposed merger that would result in a materially greater level of competition. These alternatives include whether the failing firm might be acquired by a competitively preferable third party who would be willing to pay a price that, net of the costs associated with making the sale, would be greater than the proceeds that would flow from liquidation, less the costs associated with such liquidation; whether retrenchment or restructuring would prevent the firm’s failure and enable it to survive as a meaningful competitor; and whether liquidation would result in a materially higher level of competition in a substantial part of the market relative to the merger.

Notably, the MEGs do not account for the social ramifications of a firm’s potential failure. Rather, in carrying out its review of a proposed merger (whether involving a failing firm or otherwise), the Bureau’s concern is to determine whether the merger will result in a substantial lessening or prevention of competition, and to resolve these concerns accordingly. Social issues, including whether a firm’s failure can be expected to lead to significant loss of employment or loss of shareholder value, are outside the scope of the Bureau’s review.

Merger reviews involving failing firms give rise to considerations of timeliness and efficiency that pose challenges even in ordinary economic times; however, the Bureau is committed to exploring all means of expediting these reviews. For example, the Bureau is considering devoting resources to identify industries where there have been indications that failing firm claims may be likely. In addition, the Bureau

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is considering the development of tailored information requests that could be used as an expeditious way of accessing key data in the event of a failing firm claim. Technical interfaces are also being established with the private bar to educate practitioners and their clients on the nature and scope of information necessary to assess failing firm claims in the most efficient manner possible.

These same concerns of timeliness and efficiency assume greater urgency in a multi-jurisdictional context. Importantly, at least superficially, the definition and application of the failing firm concept varies among jurisdictions. Nevertheless, guidance offered by NCAs in, for example, the United States4 and the United Kingdom5 indicates that, fundamentally, many of the considerations involved in the analysis are broadly consistent with those applied in Canada. To the extent, then, that such consistencies exist, it would be beneficial for NCAs to align their respective frameworks for analyses by communicating with one another with respect to the details of their failing firm assessments and preliminary conclusions as they are reached. Sharing conclusions regarding alternatives to the merger, including determinations of competitively preferable third party purchasers, the propriety of liquidation and the potential for restructuring, would save all agencies resources and shorten the review timelines of participating NCAs.

Should NCAs express sufficient interest in such an alignment initiative, a more formal series of meetings may be warranted in the near future to engage in preliminary dialogue on common issues, such as:

- improving procedural efficiency: for example, NCAs may wish to take steps to permit rapid access to financial experts such that these experts can be called upon to verify the financial condition of an allegedly failing firm on short notice;
- evidentiary quality: for example, NCAs may wish to consider, where feasible, establishing consistent guidance with respect to the type and scope of evidence that may be submitted to substantiate the extent of a previous “shop”; and

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4 The U.S. Department of Justice’s (“DOJ”) *Horizontal Merger Guidelines* (online: DOJ, <http://www.usdoj.gov/atr/public/guidelines/hmg.pdf>) state at page 33 that the DOJ’s failing firm analysis will consider whether: 1) the allegedly failing firm would be unable to meet its financial obligations in the near future; 2) it would not be able to reorganise successfully under Chapter 11 of the Bankruptcy Act; 3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition of the assets of the failing firm that would both keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger; and 4) absent the acquisition, the assets of the failing firm would exit the relevant market.

5 The U.K. Office of Fair Trading’s (“OFT”) recent *Restatement of OFT’s position regarding acquisitions of “failing firms”* (December 2008) (online: OFT <http://www.oft.gov.uk/shared_oft/business_leaflets/general/ofr1047.pdf>) indicates that the following conditions must be met in order to establish the failing firm defence: (i) inevitable exit of the target business absent the merger (the target business would inevitably have exited the market in the near future; having demonstrably explored such options, there is no serious prospect of the target business being reorganised); and (ii) no realistic and substantially less anti-competitive alternative (there are no other realistic purchasers whose acquisition of the target business would produce a substantially better outcome for competition. Even if such a purchaser may not pay the seller as high a purchase price or otherwise benefit the target business, the OFT will take into account any realistic prospect of alternative offers above liquidation value; alternatively, in some cases it may also be better for competition that the target business fails and the remaining players compete for its market share and assets rather than being transferred wholesale to a single purchaser).
• defining explicit timelines: for example, to the extent possible, NCAs may wish to consider establishing common timelines applicable to the various stages of the failing firm analysis and formal mechanisms for sharing conclusions as they become available.

The Bureau welcomes and encourages discussion of these and other issues relating to failing firms.

3. Conclusion

In a matter of months, unprecedented failure and consolidation have transformed the competitive structure of a variety of markets. As the economic crisis continues to unfold, NCAs must redouble efforts to convey the message that principles of competition are an essential tool, not a hindrance, to true economic recovery.

Further, economic conditions will continue to put pressure on NCAs to seek improvements to their own internal organizational processes, and to seek the benefits that may be realized through improved communication, coordination and cooperation with other NCAs, particularly in the context of failing firm analyses.
DENMARK

The Role of Competition Policy in Financial Sector Rescue and Restructuring

1. Introduction

This paper contains the views of the Danish Competition Authority (hereinafter: the DCA) on the role of competition policy in financial sector rescue and restructuring.

Section 2 presents general comments on the structure of the Danish banking sector and on recent mergers and acquisitions within the banking sector which can be attributed to the financial crisis. The purpose of providing such background information is to make clear that the views of the DCA are, in part, based on the specific structure and conditions of the Danish banking sector, which may differ from those of other OECD countries.

Section 3 addresses the specific questions of interest for roundtable II posed in the agenda for the 105th meeting of the Competition Committee.

2. General Comments

The market for retail banking is national in scope. This has been shown in numerous competition cases, including merger and cartel cases. However, no other banking markets, e.g. the inter bank market and the market for banking services to professional customers, have been delineated this narrowly. This implies that whenever the DCA has to evaluate the effects on competition of a proposed merger, the potential concerns are – almost without exception – focused on the market for retail banking.

Furthermore, with respect to concentration the Danish banking sector may differ from those of other OECD countries. The special characteristic of the Danish banking sector is that a substantial part of the retail market is covered by a large number of small banks.

There are only two large banks, Danske Bank and Nordea, each with a market share in excess of twenty per cent on the Danish market for retail banking. Two other banks may be characterized as medium sized with a market share between five and ten per cent. Finally, more than a hundred small banks with a market share of less than five per cent make up the substantial remainder of the market. The implication is that a large number of possible concentrations involving small banks must be expected to raise no or only negligible competitive concerns.

Throughout the financial crisis a number of proposed acquisitions and mergers which were a direct result of the financial turmoil were notified to the DCA. All of the notifications involved small banks with market shares below five per cent as the target of the acquisition, and all of the notifications were approved without remedies.

On two occasions the Danish government has intervened, as a direct result of the financial crisis, to maintain the stability of the financial system.
On October 10th, 2008 the Danish parliament adopted legislation (in retrospect dubbed the *first bank package*) ensuring that all claims by depositors, debt holders (senior debt) and other simple creditors in Danish banks will be fully covered by a state guarantee until September 2010. The purpose of the legislation was to ensure that Danish banks may continue to obtain loans from international financial institutions and to prevent customers of Danish banks from losing confidence and withdrawing their deposits, i.e. to prevent bank runs. At the same time the government established a company with the purpose of winding up insolvent banks. The company immediately assumed control of a bankrupt bank with a share of the Danish retail banking market of approximately 2-3 per cent. As payment for the guarantee the Danish banking sector agreed to cover losses in the new company of up to DKK 35 billion (corresponding to 2 per cent of Danish GDP).

On February 3rd, 2009 the Danish parliament passed a bill with the aim to preserve a sufficient capital base in Danish banks. The new legislation, which is called the *second bank package*, contains, most importantly, a scheme to allow banks and mortgage credit institutions (hereinafter: MCIs) to obtain loan-based capital injections from the central government in the amount of DKK 100 billion (corresponding to 6 per cent of Danish GDP). The annual interest on the loans, ranging from 9 to 11 1/4 per cent, is to be determined for each bank or MCI according to an individual risk assessment. Banks and MCIs may reimburse the loans after three years and have the incentive to do so, as the rate of interest on the loans is set to rise gradually.

The first and the second bank package have been scrutinized by the European Commission with respect to conformity with the EC Treaty provisions on state aid. The first bank package was approved on October 10th, 2008 and the second bank package was approved on February 3rd, 2009. It is important for the DCA that all measures used to counteract the effects of the financial crisis are temporary, objective, transparent, necessary, non-discriminatory and proportionate in order to avoid distortion of competition. These are the criteria applied by the European Commission to assess the conformity with the Community State Aid provisions in order to prevent distortion of competition and trade.

3. **Questions of Interest**

Within the agenda of the 105th meeting of the Competition Committee five *questions of interest* to roundtable II were posed. The five questions are addressed one by one below.

3.1 **Should competition law be set aside in the financial sector during a systemic crisis, on public interest or other grounds? If so, how should this be done?**

It is important to emphasize that the DCA has not set aside the competition law with respect to the financial sector as a result of the financial crisis. Furthermore, it should be stressed that the DCA does not have the authority to set aside the competition law under any circumstances. Only the parliament has this authority.

It is the view of the DCA that competition law should not be set aside during a systemic crisis. However, the DCA accepts that financial instability with possible detrimental economic consequences may warrant specific rescue measures. The use of such instruments should be conducted in the form of special legislation as is the case with the first and second bank package and should be temporary in nature. Hereby potential anti-competitive effects of rescue measures can be minimized. Additionally, any pressure to set aside competition law will be reduced as the need for anti-competitive measures within the banking sector, e.g. in the form of large mergers, may be alleviated.

This is not to say that the DCA should play no part in the preparation of special legislation such as the first and the second bank package. On the contrary the DCA should actively ensure that any special
legislation aimed at preserving financial stability is temporary, objective, transparent, necessary, non-discriminatory and proportionate in order to avoid distortion of competition or at least keep it at a minimum. In relation to the first and second bank package the DCA has indeed worked towards such ends.

3.2 How should competition agencies apply general competition policy rules about mergers, anticompetitive conduct and state aid during a crisis? Is it practicable to apply failing firm doctrines to mergers as crisis actions? Is the consideration required for merger review of the financial sector during a crisis different from that required for merger review of other sectors? How should negative competitive impact on the market structure in the medium and long term be assessed in reviewing mergers required to sustain the financial system?

The DCA has received a number of merger notifications as a direct result of the financial crisis, but every merger case has been considered and handled as would have been the case prior to the financial crisis. This includes an acquisition of a commercial bank by the Central Bank of Denmark.

The DCA has not been presented with a failing firm defence as a result of the financial crisis. All proposed mergers have been approved without remedies. This is likely to be due to the fact that only small banks with shares of the Danish retail banking market of less than five per cent have needed to merge to avoid bankruptcy.

The acceptance of a failing firm defence by the DCA is a theoretical possibility in a merger case where the alternative is remedies or prohibition. However, it is the view of the DCA that if such a case arose, e.g. in the form of a large scale bank merger with likely anti-competitive effects, the more likely outcome would be for the Danish government to acquire and operate the distressed bank until it could be sold with no or only negligible competitive concerns. In such a scenario the government would be in a position to adhere to competition concerns to a far greater extent than would have been possible if an initial failing firm defence had been accepted by the DCA.

3.3 To minimize negative competitive impact to the market structure in the medium and long term, are there effective measures as remedies (e.g. temporary behavioural commitments or certain monitoring measures)?

With respect to merger cases the DCA does not acknowledge that the current financial crisis should have changed the need to consider medium and long term effects on competition or the way remedies should be designed or enforced. However, with respect to instruments which are not available to competition authorities, e.g. rescue measures, application should be temporary. This will help remedy potential anti-competitive effects.

3.4 What standards and safeguards or other provisions are needed to prevent distortions of competition when government funds are used for injections of equity or guarantees?

Rescue or guarantee schemes based on infusion of government funds should be temporary, objective, transparent, necessary non-discriminatory and proportionate in order to avoid or at least to minimize the distortion of competition. On this matter the DCA is in accordance with the approach of the European Commission. Furthermore, it is the view of the DCA that it would strengthen competition on an international stage if similar evaluation criteria were adopted as international standards.

Nevertheless, it should be kept in mind that any rescue or guarantee scheme may distort competition, even if the scheme is subject to the evaluation criteria mentioned above. This is due to the fact that – at least in principle – support of any kind to a distressed company places the competitors of the recipient company at a competitive disadvantage relative to the situation without such support. Additionally, the risk of bankruptcy which is an important driver of competition is reduced by the rescue measures.
That being said, competition authorities have to accept that the present situation with its market failures is extraordinary and that preservation of financial stability is urgent given the prospective economic downturn. Therefore, competition concerns will, temporarily, attract less emphasis in the effort of governments to bring the banking sector back on its feet.

3.5 What lessons may be learned from how competition authorities have participated in responses to the recent crises and to previous events such as the Asian financial crisis of 1997? Are there any experiences from past financial crises in which measures for emergency response to the crisis in the short term, like mega mergers in the financial and other business sectors, caused greater harm to the competition in the medium and long term?

The DCA has no relevant experiences from previous financial crises. Merger control was not included in the Danish Competition Act until 2000.
DENMARK
Challenges for Competition Policy in Periods of Retrenchment

1. Introduction

This paper contains the views of the Danish Competition Authority (hereinafter: the DCA) on the challenges for competition policy in periods of retrenchment.

For general comments on the structure of the Danish banking sector and on recent mergers and acquisitions within the banking sector which can be attributed to the financial crisis see the submission from the DCA for roundtable II. The purpose of providing such background information is to make clear that the views of the DCA are, in part, based on the specific structure and conditions of the Danish banking sector, which may differ from those of other OECD countries.

Section 2 addresses the specific questions of interest for roundtable III posed in the agenda for the 105th meeting of the Competition Committee.

2. Questions of Interest

Within the agenda of the 105th meeting of the Competition Committee five questions of interest to roundtable III were posed. The five questions are addressed one by one below.

2.1 What should be the position of competition agencies towards subsidies to ailing firms or sectors? How should they respond to efforts to protect national champions and obstruct acquisitions by foreign investors?

The financial crisis should not be used as an occasion to subsidize companies outside the financial sector. The core of the problem is within the financial sector and, consequently, subsidizing non-financial companies will not solve the problem.

In the event of a political decision to use subsidies to countervail the financial crisis, those subsidies should be given exclusively to the financial sector and they should, as far as EU countries are concerned, be given in accordance with the EC Treaty provisions on state aid to avoid distortion of competition. This implies inter alia that subsidies given to the financial sector should be temporary, objective, transparent, necessary, non-discriminatory and proportionate. Furthermore, subsidies should be aimed, specifically, at preserving financial stability, e.g. by reducing the risk of a credit crunch which may pose a threat to otherwise healthy non-financial companies.

It should be noted that the number of large companies relative to the size of the economy is low in Denmark compared to most other OECD countries. For this reason the bankruptcy of individual companies will not be devastating to specific geographic regions in Denmark to the same extent as may be the case in other OECD countries.
However, should the effects of a bankruptcy be expected to hit particularly hard in one particular and well-defined region, subsidies should be given horizontally to that particular region rather than directly to the distressed company in an attempt to revitalize it.

2.2 **How should competition rules apply to acquisitions of failing firms or firms in distress, in current financial market conditions? How should negative competitive impact on the market structure in the medium and long term be assessed in reviewing mergers or state aid?**

Proposed mergers involving non-financial companies should not and – according to the Danish Competition Act – cannot be handled differently because of the financial crisis. This goes even if such mergers are a direct consequence of the financial crisis.

However, attempts at avoiding a credit crunch, e.g. in the form of government loans to maintain the capital base of the financial sector, may reduce the difficulties of non-financial companies and thereby reduce the number of forced mergers outside the financial sector. In Denmark a package with that exact purpose was passed by the Danish parliament on February 3rd, 2009, see the description of the second bank package in the submission from the DCA for roundtable II.

It should be noted that so far the DCA has not handled a merger case which was a direct result of the financial crisis and involved non-financial companies.

2.3 **Will tightening financial markets create barriers to entry and expansion in the real economy? If so, how should competition enforcement respond?**

It is an inherent risk of the current tightening of the financial markets that those companies trying to establish themselves on new markets may experience difficulties with respect to financing their operations. This can result in increased barriers to entry.

Competition enforcement should respond by constantly updating their assessment of the level of entry barriers and use only the most recent results when handling competition cases. Provided that entry barriers actually do rise due to the financial crisis, this may be the cause of tipping of decisions in competition cases, e.g. decisions in merger cases may tip towards remedies or prohibition. However, such an occurrence would not be indicative of a stricter enforcement regime, but rather of the fact that the premise of enforcement would have changed.

It should be noted that entry barriers are notoriously difficult to quantify. Therefore, the potential effects of the financial crisis on the level of entry barriers are unlikely to substantially impact decisions in competition cases.

2.4 **How should competition policy respond to proposals for modern versions of “depression” or “rationalization cartels” and similar schemes? What lessons can be drawn from previous crisis-driven policies to reduce competition, such as the self-regulation that was encouraged during the depression of the 1930s?**

The DCA has no relevant experience with depression or rationalization cartels.

2.5 **Is it necessary to consider the risk of harming long-term economic development by revitalizing failing firms or firms in distress via protective measures by the government and consequently putting other healthier firms at a disadvantage in their terms for competition?**

It is the view of the DCA that the long term effects of subsidizing failing companies should always be considered. Subsidies in any form to a distressed company places the competitors of the failing company at
a competitive disadvantage relative to the situation without subsidies. The inherent risk to economic development is to prolong inefficient business practices by lifting the failing company out of bankruptcy. Consequently, subsidies should always be temporary and not be given without prudent analysis of the cause of the distress of the recipient company.

On February 3rd, 2009 a package of government loans to banks and MCIs in Denmark was passed by the Danish parliament, see the description of the second bank package in the submission from the DCA for roundtable II. Every bank or MCI granted a loan under this scheme will be obliged to pay an interest which depends on an individual risk assessment – the higher the risk the greater the interest. The aim is to reduce the risk of offering loans on too favourable terms to weakly capitalized banks or MCIs as this will place their competitors at a disadvantage.
FINLAND

This contribution has been prepared for the third part of the roundtable which will discuss how the crisis in the financial sector will affect the other parts of the economy.

Many recent commentators have argued that the current crisis is the worst economic crisis after the WWII. Furthermore, the crisis is said to be the first financial crisis of the global age. For this reason, it is claimed that for the crisis itself, there is no clear policy map that could be set out from the financial crisis of the past. As to the implications for competition policy, the first reaction is pretty similar: the future is more or less unknown. Bearing this caveat in mind, this contribution has been divided into six subsections as follows.

1. **Competition in the crisis period decision-making. The competition authorities may face pressure to loosen enforcement standards in order to favour economic recovery. How are the competition enforcers able to show that competition is part of the solution?**

Most of the OECD countries are currently trying to stimulate their economies as a result of the financial crisis. The target is to boost private consumption and investments. Furthermore, the governments themselves are increasing public spending. Although the current crisis entails several government actions, the demand-side stimulus packages are among the most important ones to help economies out of the crisis and to the start the recovery.

Here the immediate question is whether, for the purposes of the stimulus packages, there is need to loosen the competition enforcement standards? We believe the answers is negative, for the very reason that competition rules or their targets do not necessarily at all conflict with the targets of the stimulus packages, neither with the actual and practical instruments the stimulus packages entail.

First, as for **boosting private consumption**, the most important practical instrument is the reduction of income tax and valued-added tax. Usually, these reductions are universal without any discriminatory content. This means in practice that consumers – after income tax reduction – are able to consume more, and most importantly, completely independently based on the consumers’ own preferences. In other words, universal tax reductions are not discriminatory of any industry or company, or the nationality of a company. For this reason, these instruments should not cause major anti-competitive effects.1

As a matter of fact, competition can be very beneficial in order to secure that various stimulus tools are as effective as possible. Whilst the target is that individuals consume more, it is naturally beneficial for this target that price level of goods and services originates from competition, not for instance from price-fixing cartels. Here, competition may have an important role to play, not least if the crisis will cause

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1 Naturally, the aforesaid does not exclude that competition authorities may have a need to monitor the use of the tax instruments in order to react if the instruments cause discriminatory effects, hampering competition. In this respect the multiplier effect of demand is worth noting. As governments are trying to boost demand, it is hoped that consumers would direct the demand towards domestic goods and services (ie. in order to maximize the multiplier effect within the economy that implementing and financing the tax reductions). This may encourage to introduce stimulating tax reductions schemes which are not neutral in terms of competition, and in that sense not universal.
downward pressure also on wages and on disposal income (cf. incentives to consume). Similarly as for competition and consumption, the same can be said concerning investment goods. This can be particularly important given that increase in investments is seen as one way out of the crisis itself.

Another example can be raised from the banking sector where the central banks are lowering the base interest rates. One of the purpose is to increase demand for new loans. This is believed to happen through a mechanism where banks reduce their customers’ interest rates accordingly i.e. that banks pass on the base rate cut to their customers more or less in its entirety. However, if competition among banks is not working properly, the pass-on effect does not take place and there is a risk that the base rate reduction – partly or completely – is only widening banks’ loan margins (benefits banks’ mark-ups only).

The risk is relevant especially taken into account the banks’ current liquidity situation. All in all, this would mean that base rate reduction would not have the expected stimulus effect, which may result from lack of competition. As these examples illustrate, there is a the link between well-functioning competition and the effectiveness of instruments trying to stimulate the economy.

Secondly, as for the government spending, there ought not to exist any major conflicts either. If and when the procurement rules are applied normally, competition is only beneficial in order ensure that taxpayers receive maximum value-for-money through the procurement process. This simply means that governments’ spending funds for stimulus are used as effectively as possible.2

In summary, as the secretariat points out, there will certainly arise arguments that the crisis requires to loosen competition enforcement standards. However, as argued above, there is no self-evident need to loosen the standards and there are good reasons to highlight this. Indeed, it might be beneficial for the competition authorities to have a dialogue especially with the treasuries, central banks and others stimulus scheme responsible and argue that sound competition is not necessarily in conflict with various stimulus schemes and instruments. Actually, the situation can be quite the opposite. Competition and thereby competition authorities can be important allies with the stimulus scheme enforcers in order to support the positive effect of the schemes. This message might be even more important, if the anti-competition lobby becomes influential, advocating simply their self-interests at the expense of competition.

Above, we have touched only some actions governments have introduced amidst the crisis. Naturally, we should not think that everything will be all that easy. Particularly, if the crisis is going to be a long-lasting one, more sophisticated governmental actions and radical state interventions may come into play. This, in turn, may cause more complex situations as to how compatible these actions are with sound competition policy. In this situation, the Competition Committee could certainly play an important role, as discussed at the end of the contribution.

2. Barriers to entry. Will tightening financial markets create barriers to entry and expansion in the real economy? If so, how should competition enforcement respond?

Currently and during the ongoing crisis, the picture whether the financial crisis will create entry and expansion barriers, is perhaps quite mixed.3

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2 Although it is just to acknowledge here that in terms of government spending, the question how competition is able contribute to the effectiveness of this stimulus tool, can be quite controversial both in theoretical and practical terms.

3 Here, due to the core purpose of the roundtable, we skip the difficulties relating to the definition of an entry barrier itself. For the same reason, in the following, a very broad interpretation of an entry barrier is used. Cf. OECD roundtable on entry barriers (2005).
There are certainly a number of reasons to argue that the financial crisis could impede entry and expansion. First, companies planning an entry may have severe difficulties to obtain finance for the entry. Cash reserves could be an alternative, but amidst the crisis not necessarily a realistic option for all. Secondly, in many markets there is a sharp decline in demand, which is not an encouraging factor for entry itself. As for the academic literature, the role of finance has often been considered important if not for the entry itself, but for post-entry market expansion especially.

As for pro-entry parameters, the crisis can be beneficial especially for efficient and cost-effective new entrants. Along with that, the crisis may cause the customers become more price-sensitive as demand is likely to become more price elastic, which should favour new, more efficient entrants compared to possible non-efficient incumbents. Furthermore, despite the crisis and the declining demand that probably will come with it, the market can be very lucrative in the long run (especially if, as a consequence of the crisis, the non-efficient incumbents are forced to exit the markets).

Finland witnessed a very severe economic crisis in the early 1990’s. Overall, during the Finnish crisis, there was a clear concentration development in several sectors of the economy. However, as the crisis began to release its grip and the recovery started to speed up, several new foreign entrants started to establish their branches in Finland. This happened in a number of markets, including banking, construction and the retail trade. Interestingly, for entrants, all these three sectors are often considered as high sunk cost businesses. Another interesting point is that the majority of entrants entered from Sweden, which also quite recently had experienced a severe economic downturn.

As for new entry in banking during the Finnish economic crisis, we can assume that new entrants also brought new liquidity into the markets, perhaps supporting the recovery of the economy, at least for some part. As the Finnish banking sector concentrated heavily during and as a result of the economic crisis, new entrants were naturally much welcomed in terms of competition as well. As regards the construction sector, one new Swedish entrant gained quite rapidly a relatively robust market position in Finland. The nature of the construction markets as typical bidding markets certainly contributed to their successful entry.

Due to the aforesaid experiences, it is no surprise that barriers to entry will certainly be a very important field of action for the Finnish Competition Authority, especially if the crisis will be long and if the development of disoptimal market structures start to take place.

3. Failing firms. How should competition rules apply to acquisitions of failing firms or firms in distress, in current financial market conditions? What should be the position of competition agencies towards subsidies to failing firms or sectors (to revitalize failing firms or firms in distress) and towards other protective measures by the government? As a consequence, healthier firms may end up having disadvantage in their terms for competition.

As for the acquisitions of the failing firms, a clear general rule and starting point should be the application of the ‘normal’ failing firm practice of the authority. Therefore, the already established failing firm enforcement principles – if these exist - should prevail. Although failing firms always require a case-by-case assessment, there might be good reasons for the competition authorities to consider issuing some guidance about the matter. This is especially the case if the crisis will drag on.

In terms of subsidies, and without going into the details, for the competition authorities the normal competition neutrality principles are something to start with and to screen the potential problems through them. Naturally, purely the analytical task itself will be very challenging for the authorities, especially in the current economic environment.
Perhaps the broader picture of subsidies is the possible danger of a so-called ‘subsidy race’. By this, we mean a situation where countries and governments find themselves more or less in competition with each other to subsidize their domestic national champions. Evidently, the winners of this race are those governments which have the most resources to financially support their firms, including their national champions. The deeper your pockets are, the more probable it is that the national champion your government is subsidising will come out of the crisis “alive and well”. Moreover, after the crisis, the champion is ready to gain ground in other markets as well, both domestic and foreign.

If the kind of race would take place, as a result of it, not only a national champion but basically any other company which does not have the luxury to receive funding from their governments, could sooner or later be practically out of the markets in one way or the other. The national rescue operation of national champions may also include some other tools than just financial ones, e.g. different protectionist measures.4

Naturally, for all the small and open economies, the risks of a potential subsidy race can be very worrying. The fact that the economy is open naturally means that the markets open for any entrant, whether foreign national champion or not and whether entering the markets subsidised or not. Acknowledging the fact that these matters are also closely linked with trade policy, it is in the interest of competition as well that the governments’ asymmetrical policies could be avoided in this respect.

4. National champions. How competition authorities should respond to efforts to protect national champions? How competition authorities should respond to efforts to obstruct acquisitions by foreign investors?

Those possible situations, arising outside the area of competition enforcement, where some short run political reasons are actually the only basis to protect national champions, can be challenging for the competition authorities. A possible starting point for policies as well as for competition authorities as well, could be to focus on the industry configuration or the clusters. If targeted at relevant nodes of industry clusters, the competitive process in the supply chain may not be that seriously hampered provided that the aid within these nodes is distributed on a basis that reflects not only the weight but also the merits of each firm. It can be questioned whether an economy can afford to discriminate against firms that have on their merits managed to avoid severe crisis. When applying principles that do not relatively harm firms that have meritoriously survived the downturn, the policy that apparently favours national champions, may prove to be a policy enhancing competition.

In any case, the aforesaid does not warrant that e.g. in terms of merger control the approach should be somehow different for national champions than for others.

5. Competition restraints based on crisis justification. How should competition policy respond to proposals for modern versions of “depression” or “rationalization cartels” and similar schemes? What lessons can be drawn from previous crisis-driven policies to reduce competition, such as the self-regulation that was encouraged during the depression of the 1930s?

Studies of recovery from fundamental crises, such as the great depression in the 1930s, and experiences from more recent domestic recessions, may contribute substantially to our understanding regarding the dynamics and interplay between recovery and competition.

4 The OECD countries are already aware of the tax competition among countries. In the worst scenario, the financial crisis may potentially cause similar situations through the subsidy race of national champions.
Academic studies show that policies including provisions that weakened the implementation of antitrust laws in conjunction with demand boosting policies may actually slow the process of recovery. The explicit mechanism behind a slow recovery was a combination of allowing de facto price fixing together with simultaneous increase in wages due to increased bargaining power of the labour. Such mechanisms may traditionally cause tension between insiders and outsiders, with the recovery and planned indirect increase in employment figures being suppressed.

The present structures of the European economies may differ from that in United States during the New Deal era, but the lesson may not be disregarded. Rising unemployment figures have always created tension between insiders and outsiders and the recovery from severe crisis may be accompanied by pressure to lessen the emphasis put on antitrust enforcement. Our experiences on the recovery from more recent crisis attest that active competition policy does not hamper the process of recovery. The recovery from severe depression in the early 1990s was relatively swift, and was not accompanied by fiscal stimulus via increased government expenditure. This export-led growth, was partly due to changes in monetary policy. More significantly, this era was not accompanied by a relaxed antitrust enforcement. With the imminent European integration process, the development was thus rather opposite to the one described in the academic study of U.S. New Deal policies. Price regulations were being abandoned, and policies were paving the way for a smoother working of the market mechanism. It is hardly an understatement to say that antitrust enforcement was intensified during this era of recovery, which however does neither establish nor refute causality.

Although competition policy may be an active ingredient in the recovery process, it hardly plays the role of ‘activator’. Its active presence is recognized in competition advocacy, influencing policies to reduce barriers to the entry of new firms, the role of which is stressed by Lindbeck & Snower (2002). The role of active competition policy is important in ensuring the long run viability of policy measures taken during the revitalization process. The challenges of recovery should not be met by precipitate changes in competition policy in a way that could lead to divergence between national policies. A policy implication formulated by Lindbeck & Snower (2002) highlights that the locus of challenges associated with required change may lie elsewhere than in the field of competition policy. (to quote, p. 41 (own parenthesis)):

"Another general policy implication of the insider-outsider theory concerns the magnitude of required policy change. As noted, labor turnover costs (LTCs) discourage firms from hiring and firing, thereby creating a corridor of wages within which employment is not responsive to policy stimuli. Consequently "timid" labor market reform – in which policy parameters are changed by only small amounts – are likely to be ineffective in labor markets with significant LTCs. Then only "bold" reforms can stimulate employment."

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In June 1991, the Finnish Markka was tied to European Currency Unit ECU, at a overvalued rate. Speculations forced to devaluation of the Finnish Markka by 5.75% in November the same year. This devaluation did not restore confidence in the currency and in September 1992 the currency was allowed to float, which lead to a further substantial depreciation of the Markka. In 1999, the third stage of EMU meant that the exchange rate was irrevocably fixed to the Euro (EUR) at an exchange rate of 5.94573 FIM/EUR

6. Long-term policy issues. Should negative competitive impact on the market structure in the medium and long term be assessed (for instance in reviewing mergers or state aid)? Overall, is it necessary to consider the risk of harming long-term economic development?

6.1 What can be at stake?

Many of the major economies in the world are practically in recession. However, the length of the current crisis is unknown. By definition, when the economic downturn has already developed into a recession, there are no quick solutions to turn the situation around. This is especially conceivable given that the current crisis is a global one and the overall demand is sharply decreasing throughout the world.

For competition policy, the length of the crisis can also be extremely important. If there would be new indicators available soon, showing that the crisis will be somewhat short, the competition authorities would be more confident to carry out competition law enforcement close to normal. Unfortunately, this scenario is unlikely.

As for the opposite, a long and severe economic recession, it will probably increase pressure towards the competition authorities to loosen or soften the enforcement standards. Furthermore, the longer the recession will continue, the risk that for instance various anti-competition regulatory schemes become difficult to repeal or even permanent, will increase as well.

The competition authorities may need to prepare themselves for that fact that a severe long-term crisis may require them to be more tolerant. However, in relation to the limits of their flexibility, it is important to stress that the discretionary powers of the authorities are often restricted already by the law itself, merger control mentioned as one example of this.

Furthermore, if the compromises that the competition authorities may have to accept will spread too far and wide, even credibility issues can at stake. The task to preserve competition policy and culture from severe and irreparable damage cannot be compromised.

6.2 Why competition in the middle of a crisis?

As for the long-term effects, it is certainly important to consider the risks of harming long-term development as a result of the crisis. But, it may not be an optimal solution that these risks are assessed by the competition authorities only. Far more important may be that also those responsible for the general economic policy, like treasuries and central banks, assess and take stand on the role of competition during the crisis.

Even in an economic crisis, competition has an important role to safeguard that the economy maintains its dynamics and vitality. As competition authorities are trying to convince the other decision-makers that competition is a solution even in a crisis, two specific ’crisis-related’ reasons can be brought up here.

First, economic crisis may cause inflatory pressure in the economies because economic actors - due to the crisis - have often postponed their consumption and investment needs, maybe for years. This may

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All in all, the role of advocacy will be very important during the crisis, not only for the reason that several policy and decision makers may seek consultation from the competition authorities e.g. concerning competition neutrality issues. In addition, the competition authorities themselves may have a strong need to constantly monitor possible new regulatory instruments more closely and actively than they would do in normal economic environment. If the result of this monitoring requires action, advocacy is often the right tool.
relate to both household consumption and to corporate investments. In any event, when the economy begins to recover there may in the economy exist a very substantial piled-up demand as the demand has been lagging behind, perhaps for many years.

At the same time, the supply-side may not be immediately ready to fulfill the rapid recovering of the economy and the strong increase in demand that comes with it. In this situation competition has naturally an important role to play, but there is a need to maintain viable competition already during the crisis if the post-crisis and recovery-period benefits are to be achieved. The benefits can not be gained if competition starts only gradually to ‘wake-up’ at the same time when the economy itself is already in the recovery process.

Secondly, it is self-evident that a tight control of inflatory pressures is highly important, not to say critical, if the economy is planning to succeed in foreign export markets. Besides, the export markets may recover sooner than the domestic ones. This, in turn, means that success in the export markets requires domestic markets to be kept competitive, even if the domestic recovery would not have started yet (and domestic inflatory pressures not yet at hand).

These crisis-related illustrations above are just two examples to argue – against the anti-competition lobby, for instance – that competition should play an important role even during an economic crisis. Here, the question may no longer be about the competition policy as such, but merely of the nation’s economic strategy as a whole. For this reason the question of a crisis period competition policy is almost unavoidable also among those responsible for the economic policy in general.

6.3 What next?

Quite a few of the OECD member countries introduced and developed modern competition rules from the 1990’s onwards. Simultaneously, the economies have been on a constant upward slope in growth. Perhaps for this reason, the competition law reforms have gained acceptance more easily, without major objections from various stakeholders of the economy. In many countries, a continuing positive economic cycle may have helped to strengthen the competition regime and the enforcement of it. Now, the acceptance of the objectives of a modern competition regulation can be in its first real test in a number of countries.

When the Competition Committee held its 100th meeting in February 2008, the Finnish Competition Authority in its written contribution made an observation according to which

“there is still need for the competition community to be able to explain what are the real benefits of competition, and in the positive sense continue the popularization of the message. In any case, the textbook argument for competition is no longer enough, and in future solely this kind of argument will be strongly challenged unless more in-depth examples from real life can be presented as well. “

Unfortunately for the competition authorities, the crisis will not make the future any easier in this respect. The positive part is that in many countries the stimulus packages and tools are somewhat similar. For this reason, these packages and tools can possibly have somewhat similar competition effects and raise similar competition problems as well. This should emphasize the need for the competition authorities to update each other of the relevant developments, and perhaps most importantly of the results of authorities’ crisis-era policies.

The Competition Committee and its working groups would be excellent candidates to coordinate this task.
GERMANY

Challenges for Competition Policy in Periods of Retrenchment

With the dramatic crisis affecting the financial markets, particularly since last year, (re-) financing opportunities for companies in the real economy have distinctly worsened. Banks are demanding higher interest rates or the presentation of increased guarantees for the credit facilities they grant to companies. Companies have to adjust their business operations to lower liquidity levels and if necessary shelve any planned investments. At the same time they are confronted with a decline in sales due to weaker private consumption. In the globalised economy, which is marked by interdependence at various levels of the value-added chain, companies in all regions of the world and all areas of the real economy are affected by these developments.

Compared with financial markets, real economy markets are generally associated with lower systemic risk. Consequently the risk of permanent harm to the markets due to the exit of individual companies from the real economy is rather low. However, the deep crisis, with a worsening in the credit rating of companies and loan default, is causing further problems for the already weakened banks, with the result that the large-scale deterioration of conditions in the real economy could in turn increase the systemic risks for the banking sector.

The unavoidable adjustment process in the real economy inevitably involves painful consequences for the economy and society, such as mass layoffs of the workforce and the exit of companies from the market.

The policy of the state is to assist the adjustment processes and cushion the negative effects for companies and consumers. In the following, possible approaches will be discussed and analysed from a competition perspective.

1. **Industrial policy approaches**

An industrial policy approach which is in constant discussion is the creation of national champions, i.e. the targeted promotion by the state of individual companies to enable them to stand their ground in global competition. With the aid of selective state promotion these companies acquire a magnitude and a national or even international market position which they would not have achieved without state promotion. Unlike with the natural growth of a company under market conditions, in the case of a national champion, competitive forces are overridden by state intervention. The call for the creation and promotion of national champions, usually with the aid of state subsidies and other advantages awarded by the state, comes from the economy just as much as the political sector.

A national champion policy is justified above all by the argument of the need to maintain a national presence in the world markets, to secure and create jobs and the notion that the promotion of certain sectors (e.g. IT, aviation/aerospace) has far-reaching positive effects on economic structure.

Any advantages of the creation of national champions are countered by serious problems such as:
• The state does not know in advance which sector and which company has a promising future and is worth promoting. It is primarily the competitive process, not a state planning decision, that decides which products, services and technologies are in demand.

• State promotion (in the form of subsidies or special conditions) for individual companies creates distortions of competition for other companies which receive no support from the state. Subsidies are often financed by taxes, which fall to the burden of non-subsidised companies and increase their costs.

• State promotion can also involve a reduction in jobs in non-subsidised companies; ultimately a number of productive, competitive jobs can be replaced by less productive jobs.

• The promotion of national champions can lead to market dominance with all its negative consequences for competitors and other market levels.

• The promotion of national champions involves the risk of retaliatory measures by other states, which can lead to an international race to subsidize and end in protectionism.

Past experience shows that national champion projects have failed time and again. Due to its numerous imponderables, a national champion policy is not a suitable instrument for the state to overcome economic crises. It even poses serious economic risks because of its immanent market-distorting effects and inefficiencies and the threat of retaliation by other states.

German economic policy rejects the industrial-policy approach of the national champion concept and emphasizes that, in general, market processes should not be distorted by state intervention. This not only applies to industrial policies of active intervention. German law does not allow the state to intervene in market processes for industrial-policy reasons with the aim of preventing developments, e.g. to reject a merger project because of the acquirer’s “nationality”. The only exception to this rule is the narrowly defined provision in a draft bill, where a merger involving foreign participation poses a threat to public order or national security.1

2. Competition policy approaches

The German competition regime as reflected in the Act against Restraints of Competition (ARC), which has been the basis of the Bundeskartellamt’s work since 1958, can make a contribution to overcoming the current crisis.

The “Topics for Discussion” for this Roundtable raise the question whether "depression cartels" can contribute to solving the present crisis.

In this respect it is useful to take a look at the development of the German economic and competition system. The ARC is the result of a development dating back to the 19th Century, a time when, in Germany, cartels of all types, even price agreements, were seen as an outcome of unfettered trade and business and were thus not found to be objectionable. However, at least since the hyper-inflation phase from 1922 to

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1 See draft bill to amend the German Foreign Trade Act: Section 53 AWG-E, online at: http://www.bmwi.de/BMWi/Redaktion/PDF/Gesetz/entwurf-eines-dreizehnten-gesetzes-zur-aenderung-aussenwirtschaft,property=pdf,bereich=bmwi,sprache=de,rwb=true.pdf. If the respective preconditions are fulfilled, the bill enables the Federal Government to retroactively prohibit investors from outside the European Union and EFTA from acquiring voting shares in German companies starting from a participation of 25 per cent.
1923, the negative effects of the quasi-nationwide cartelisation of the German economy became obvious as the industrial sector used its cartel structures to pass on the consequences of inflation to the consumer. With the seizure of power by the National Socialists in 1933 cartels became a handy organisational structure enabling the state to gain central control of the economy. After the end of the Second World War, under the Allies’ decartelisation and deconcentration policy and the influence of the “Freiburg School” (ordoliberalism), which paved the way for the ARC, the current competition regime was developed which generally bans cartels and only allows for narrowly defined exceptions. 2

Until the last amendment to the ARC in 20055, one of the possible exemptions from the ban on cartels under the ARC was the so-called structural crisis cartel (Section 6 ARC old). This tool was aimed at reducing overcapacities in a market that were the result of a long-term change in demand (structural crisis) whilst protecting the competitive structures as far as possible. In order to obtain an exemption decision by the Bundeskartellamt, the cartel members had to submit a detailed plan on how they intended to overcome the crisis speedily and without discriminating against individual companies.4

Companies made little use of this exemption possibility. During all the decades that the provision was in force, only two structural crisis cartels were exempted. In 1985 a cartel for the production of welded steel mesh was legalised5; another legalised cartel concerned 17 producers of lightweight building boards6. Although informal consultations with the Bundeskartellamt took place in several other cases, these did not lead to applications and even less to clearances. In most of the cases, the companies decided not to enter into cartel agreements because they were not willing to undergo the painful adaptation processes required in the case of a structural crisis cartel7.

Experience in Germany shows that cartels only rarely offer comprehensive solutions to economic and structural problems. Cartel members try to alleviate the pressure of structural adjustment by passing on the costs of the crisis entirely to the opposite side of the market in a concerted way. Cartelisation hardly ever offers problem solutions that are superior to the competitive process.

The Bundeskartellamt has the necessary flexible tools and procedures to satisfy the justified demand of companies for swift action in difficult economic circumstances, while at the same time fulfilling its tasks. For example, merger control procedures allow for a prompt reaction to structural adaptation requirements in the markets. In principle, concentrations must be notified to the Bundeskartellamt before they are put into effect and may only be realised after their examination under competition law has been completed (Section 39 (1) ARC). In exceptional cases, such as when the existence of a participating company is threatened, the Bundeskartellamt may grant exemptions from this prohibition of putting a concentration into effect, which normally applies for the duration of the merger examination under competition law (Section 41 (2) ARC). This exemption does not suspend the time limits regime that allows the Bundeskartellamt one month for the examination of a concentration (so-called first phase) and an additional three months for a more detailed examination (so-called second phase). In addition, the exemption from the prohibition of putting the merger into effect does not have any predetermining effect

3  The 7th amendment to the ARC entered into force on 1 July 2005.
4  Under very limited conditions structural crisis cartels can also be exempted from the ban on cartels (Art. 81 EC) under EU law, see, for example, Commission decision of 23.12.1975, “URG”, Official Journal L 051/7 para. 34.”
7  Cf. Bechtold: ARC §6 para 1
on the final decision of the Bundeskartellamt and can be granted subject to conditions and obligations. However, it enables companies to put into effect a company saving concentration quickly and flexibly where the actual market situation requires it. At the same time, the Bundeskartellamt is given enough time to carry out the necessary investigations before its final decision.

In addition to the tools and procedures for structural and behavioural control, another tool is gaining weight in times of economic crises: the tool of competition advocacy. In such times of crisis, competition advocacy can be used as a counterweight to increasingly loud calls for government measures to protect the national economy. This could be seen in the debates on economic policy measures in recent months, in which independent players, such as the German Monopolies Commission, raised their voices in view of vociferous advocates of sectional interests to ensure that the principles of regulatory policy are not forgotten by those responsible for economic policy measures.
GERMANY

Adaptation of Competition Rules, Processes and Institutions to Current Financial Sector Issues

The ongoing financial crisis has starkly highlighted how vulnerable financial institutions and markets are. In the face of the acute challenges in the financial sector – and, increasingly, also in the real economy – competition enforcement has had to adapt and show flexibility, e.g. when it comes to the swiftness of conducting merger review. Beyond emergency measures, the question of longer-term adjustments to the framework of competition law enforcement and regulation in the financial sector with the aim of contributing to system stability – without detriment to competition – is a salient one. It is clear that – both with regard to immediate flexibility and longer-term adjustments – competition law can and needs to make its contribution to solving the crisis.

This contribution starts with an overview of the structure of the banking sector in Germany to help assess the significance of the financial crisis in this sector of the economy. It then presents a measure by the German government and the legislator aimed at preempting the fallout of the financial crisis. Taking a lead from the “Topics for Discussion” to this roundtable, it looks at the question of whether and how system stability criteria should be integrated into competition policy and turns to the issues of cooperation between competition authorities and financial sector regulators and to a measure discussed with a view to improving conditions for competition in the financial sector.

1. Structure of the banking sector in Germany

Over the years – and well before the financial crisis was on the horizon – the highly deconcentrated banking sector in Germany has seen continuous consolidation, with the number of banking institutions decreasing from ca. 3,200 in 1999 to still more than 2,000 in 2008. The degree of competition in the sector is deemed to be high.

The banking sector in Germany consists, broadly speaking, of three segments – private banks (Privatbanken), savings banks (Sparkassen) and mutual banks (Genossenschaftsbanken). A forth segment comprises specialized banks.

Merger control cases that warranted particularly speedy review by the Bundeskartellamt were: Landesbank Baden-Württemberg/ Sächsische Landesbank, Lone Star Fund/ Industriekreditbank, Bundesverband Deutscher Banken/ Düsseldorfer Hypothekenbank. Given the rather high degree of competition in the German banking sector, serious competition problems did not arise in the banking mergers reviewed.
• Private banks: There are four large private banks in Germany, as well as approx. 160 smaller private banks, a large number of them with a strong regional focus in their business activities. Furthermore, there are numerous affiliations of foreign banks active in the German banking sector.

• Savings banks: There are more than 400 savings banks in Germany, which are organized on a basis of regional activity. A (regional) savings bank is mainly dedicated to serving customers in its particular region. It is closely linked to the local/ regional administrative entity, i.e. the municipality or the administrative district, as the administrative entity controls the savings bank. A savings bank is typically independent of other savings banks, however there are eleven “Landesbanken” (four of which are controlled by others of the remaining seven Landesbanken) which act as “central banks” for the savings banks in their territorial responsibility.

• Cooperative banks: There are approx. 1,200 cooperative banks in Germany. Cooperative banks usually have a predominantly local or regional outlook, in terms of their business policies and the customers they service. Each cooperative bank is typically an independent entity, however there are two large banks (about to merge into one) that serve as “central banks” of sorts for the mutual banks.

• Specialized banks: Besides these types of banks, there are specialized banks, among them institutions focused on mortgage business.

There has been notable fallout of the world-wide financial crisis in the German banking sector, the scope of which is still not fully assessed. The first and hardest hit by the financial crisis have been banks with large positions in international real estate financial products that have turned bad. Early cases of German banks affected by the financial crisis were: Sächsische Landesbank, IKB Industriekreditbank, Düsseldorfer Hypothekenbank (cf. footnote 1), the most dramatic case is that of Hypo Real Estate.

A considerable portion of the banking sector in Germany has, at least so far, coped comparatively well. This may be because of the relatively strong local/ regional focus in the business of the vast majority of financial entities; not surprisingly those institutions that have suffered most in the past months are those with a marked international/ world-wide dimension to their business. Whether the relative stability of the less internationalized segments of the financial sector will endure is far from clear, however. The reverberations for the financial sector as a whole from the cases of banks in Germany and beyond that find themselves in dramatic positions may turn out to be severe.

2. Emergency measures to counter the fallout of the financial crisis

The German federal government and legislature have taken measures to preempt a more devastating fallout of the financial crisis on the financial sector and – as a consequences of that – on the real economy. The “Finanzmarktstabilisierungsgesetz” (FMStG – Act Concerning the Stabilization of Financial Markets) of 17 October, 2008, establishes the basis for creating a state fund of the German federal government specifically intended to acquire stakes in financial institutions that are in distress. This new provision has ramifications for merger control. In order to allow emergency rescue operations to go into effect swiftly, the FMStG (Art. 2 Section 17) states that the relevant provisions of the Act against Restraints of  

2 The term “private bank” is to be understood as a category setting these institutions apart from cooperative banks and (public) savings banks. The equity of private banks is held by investors, a number of private banks are publicly listed.

3 These are Deutsche Bank, Commerzbank (post-merger with Dresdner Bank, end of 2008), Postbank, HypoVereinsbank (affiliate of Unicredit).
Competition (ARC) are not to be applied to the newly created state fund. Specifically, this means that the acquisition by the state fund of a stake in a company of the financial sector is not subject to merger control by the Bundeskartellamt.

Any exemption from the general rules of competition law, and particularly a sweeping one like the broad exemption for the state fund under the FMStG, warrants skepticism or at least careful scrutiny. The provision is an emergency measure in a dramatic economic situation. Therefore, the legislator has accepted that – at least for the limited period of time that the state fund will be in operation – a dominant position might occur. Due to the rather de-concentrated structure of the financial sector in Germany, this is not very likely, though. The exemption from merger control created by the FMStG is based on public interest considerations. Here, one might see a parallel with public interest considerations to be made by the Minister of Economics in a ministerial authorization under the German merger control regime.

However, the argument for exempting state fund transactions from merger control does not apply once state-owned companies are sold back into the market. These transactions need to be subject to regular merger control.

3. Integrating the concept of system stability into competition policy

The FMStG offers a tool for swift state rescue actions in the financial sector and is to be viewed as an emergency measure to be used for the limited period of a serious crisis. It is not a tool intended to introduce a new paradigm into competition policy to make the financial sector inherently more resistant to crisis.

An idea put out for discussion in the “Topics for Discussion” for this roundtable for pursuing the aim of stability is to extend the concept of consumer welfare to include macroeconomic benefits from ensuring system stability.

Germany is a jurisdiction that does not directly apply the consumer welfare standard – or any other welfare standard – as the decisive guiding principle in competition law practice. Rather, the German competition law framework focuses on protecting the competitive process. This, of course, in the longer term benefits consumers, as was already stated in the original explanatory memorandum to the German Act against Restraints of Competition of 1957. In a similar vein, the explanatory memorandum refers to a competitive market economy as the system best suited to promote general welfare.

4 Text of the legal provision: „Die Vorschriften des Ersten bis Dritten Teils des Gesetzes gegen Wettbewerbsbeschränkungen finden keine Anwendung auf den Fonds.“

5 The ARC stipulates that in its competition law proceedings, including merger control, the Bundeskartellamt is to consider solely competition aspects. For the field of merger control, the ARC contains a provision that allows for including non-competition aspects of public interest in assessing a concentration. However, this assessment is reserved for the Minister of Economics and Technology and can only be initiated – by application of the parties to the merger – after the Bundeskartellamt has rendered its decision. The relevant provision in Section 42 of the ARC states: “The Minister of Economics and Technology, upon application, authorizes a concentration prohibited by the Bundeskartellamt if, in a specific case, the restraint of competition is outweighed by advantages to the economy as a whole following from the concentration, or if the concentration is justified by an overriding public interest.”

6 “The ‘Act against Restraints of Competition’ ... is intended to safeguard the freedom of competition and to overcome economic power wherever it infringes the effectiveness of competition, its tendencies to improve efficiency, and the best possible servicing of consumers.”, Deutscher Bundestag, Begründung zu dem Entwurf eines Gesetzes gegen Wettbewerbsbeschränkungen, Drucksache 1158, 1955, S. 21 f. (Translation and italics by the Bundeskartellamt).
If one were to look at the issue of system stability in the context of the German competition regime and conclude that this was not a criterion covered by the established competition standard, then the factor of stability would have to be seen as one of significant public interest.

However, it seems more adequate to treat system stability for what it is: Not an added feature to be considered amongst many others, but rather a fundamental condition that is a prerequisite for workable competition. Thus: if, for example, a proposed merger promises to safeguard system stability that would otherwise be in danger of collapsing, then one may conclude that the merger protects the very basis of a competitive market regime. Considering this when applying the competition standard should not pose insurmountable problems.

The argument should be a similar one when conducting competition analysis under a welfare standard – regardless of whether one applies a consumer welfare standard or any other welfare standard.

Thus, the real problem in considering system stability in competition law analysis does not arise at the conceptual level of how to integrate the benefits of system stability into the specific standard applied in a particular competition policy regime. The difficulty is rather a practical one, i.e. to make sure that only genuine systemic issues are considered, and to draw the line where “merely” desirable policy goals that do not have a systemic relevance are concerned.

4. Cooperation between the Bundeskartellamt and financial sector regulators

In the German regulatory system, the Bundeskartellamt, as the competition authority, and financial sector regulators have traditionally performed their respective functions in parallel, without a large degree of interaction. Thus, in merger control mutual consultation has always been limited, given that the focus of inquiries and the criteria of assessment are quite different. In the cases of cooperation agreements or dominance, German competition law used to contain sector-specific rules for banking that called for consultation with the sector regulators in specific situations. In practice, these rules have been of very limited significance. With the drive by the German legislator to eliminate sector-specific exemptions from competition law, the remaining special rules for the banking sector were abolished. In this context, the provisions on mandatory consultation between the competition authority and banking sector regulators were scrapped.

Since the focus of the Bundeskartellamt, as the competition authority, and the focus of the banking sector regulators are quite different, it was a logical step to do away with the strict legal requirements for consultation. However, this should of course not stand in the way of information exchange if the agencies have the chance to learn from each other’s experiences and insights. After all, Section 50c ARC grants explicit permission for cooperation between the Bundeskartellamt and financial sector regulators.

5. Possible measures to improve competitive conditions

Against the backdrop of the financial crisis, system stability is of course an overriding goal. Any measure to improve competitive conditions must be careful not to imperil this objective. One measure that has been brought into the discussion is the portability of bank account numbers, i.e. the possibility for an account holder to hold on to the identifying code of a bank account even when he switches to a different bank.

This measure may have the effect of reducing switching costs and thus of eroding an impediment to competition, and it is likely to be neutral with regard to system stability. However, given the experience in Germany it is doubtful whether such a measure would be warranted. Competition in the retail banking sector in Germany is comparatively strong, especially with the advent of direct banking. Banks seem to be aggressive in wooing customers to switch accounts, and try to make switching easy for new customers by
offering to take care of transfer arrangements in this context on behalf of the new customer. It is far from clear that a rule of account number portability would make a decisive difference. Against the possible, but not at all certain gain in terms of the degree of competition that may result from account number portability one needs consider the burden of imposing a new regulatory framework on the banking sector and the costs of changing from the old system to a new one which the sector and its customers would have to bear.
1. Introduction

This is the written submission from the Irish Competition Authority (“the Authority”) to the February 2009 OECD Competition Committee Roundtables on Competition and Financial Services. The submission considers the measures taken by the Irish Government to ensure the stability of the financial system in Ireland and the likely impact on the application of domestic competition law to the financial services sector.

2. Legislation to Ensure Stability of the Irish Financial Sector

Over the last few months, the Irish Government took steps, including the introduction of new legislation, to ensure the stability of the Irish financial system. In particular:

- In October 2008, the Irish Government enacted The Credit Institutions (Financial Support) Act 2008 (the “Credit Institutions Act”). The Credit Institutions Act provides for a guarantee arrangement (the “guarantee scheme”) to safeguard all deposits and liabilities in the banks that have signed up to the guarantee scheme. In addition, the Credit Institutions Act enables the Minister of Finance (the “Minister”) to take jurisdiction over a merger or acquisition that he determines is required to ensure the stability of the Irish financial system.

- The Irish Government also announced an intention to recapitalise certain banks that signed up to the guaranteed scheme.

- In January 2009, Anglo Irish Bank (“Anglo”), the third major Irish bank, was nationalised. The Anglo Irish Bank Corporation Act 2009 (the “Anglo Act”), the emergency legislation that gave effect to the nationalisation of Anglo, specifically disapplies the Competition Act 2002 (the “Competition Act”) to the government’s nationalisation of Anglo.

3. The Guarantee Scheme (The Credit Institutions Act)

The guarantee scheme envisaged in the Credit Institutions Act was enacted by a separate statutory instrument passed by the Houses of the Oireachtas (the Irish Parliament) on 17 October 2008, the Credit Institutions (Financial Support) Scheme 2008. The guarantee scheme covers all existing and new deposits (retail, commercial, institutional and interbank), covered bonds, senior debt and dated subordinated debt (lower tier II) with the institutions concerned; this is valid to 29 September 2010 inclusive. The guarantee scheme was approved by the European Commission (“Commission”) under EC rules on state aid on 13 October 2008.

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1 They are: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society. Postbank Ireland Limited was subsequently added to the list of the institutions covered by the guarantee scheme.
The Credit Institutions Act modifies certain provisions of the Competition Act in order to allow the Minister to review and make a decision on any merger or acquisition in the banking sector which meets the criteria set out in section 7(1) of the Credit Institutions Act.

In particular, section 7(1) of the Credit Institutions Act provides that:

“This section applies to a merger or acquisition (within the meaning of section 16 of the Act of 2002) that involves a credit institution or subsidiary where the Minister:

(a) after such consultation with the Central Bank and the Regulatory Authority as the Minister considers necessary, is of the opinion that:

1. the proposed merger or acquisition is necessary to maintain the stability of the financial system in the State, and
2. there would be a serious threat to the stability of that system if the merger or acquisition did not proceed, and

(b) certifies in writing to the parties to the merger or acquisition, the Competition Authority and the Governor that he or she is of that opinion”.

(Emphasis added)

Under the Credit Institutions Act, certain mergers and acquisitions involving banks are not notifiable to the Authority and the Minister is not obliged to seek the Authority’s advice on competition in respect of mergers notified to him.

The Authority will only have jurisdiction to review a merger or acquisition notified to the Minister, if:

a. the Minister is of the opinion that such a merger or acquisition does not meet the criteria set out in section 7(1) of the Credit Institutions Act; or

b. the Minister is of the opinion that such a merger or acquisition meet the criteria set out in section 7(1) and, under specific terms, requests the Authority to investigate the merger or acquisition.

Under the Credit Institutions Act, the Authority is required to provide any advice, information and assistance that the Minister may require for the purposes of making a decision. The Authority considers that the word “assistance” might include the Minister requiring the Authority to investigate a merger or acquisition which meets the criteria set out in section 7(1) of the Credit Institutions Act. If this were to occur, the Authority expect that the Minister would:

- give clear indications to the Authority with regard to the scope of its investigative role, and
- allow the Authority to use the investigative powers set out in section 20 of the Competition Act\(^2\).

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\(^2\) Section 20(2) of the Competition Act sets out the power of the Authority to request information from the undertakings concerned, i.e., power to issue formal requests of information. However, section 17 of the Credit Institutions Act transfers this power of the Authority to the Minister with regard to a merger or acquisition that meets the criteria of section 7(1) of this Act.
4. Recapitalisation of the Irish Banking System

The Irish Government has announced an intention to inject new capital in the two major Irish banks, stressing its preference for co-investment by existing shareholders or new private investors in the recapitalisation of the banking system in Ireland. At the time of writing this submission, the recapitalisation plan, envisaging a total capital injection of up to €8 billion split equally between the two banks, is being discussed but no final decision has yet been made.

5. The Anglo Act and the Competition Act

The Anglo Act disapplies Part 2 (anti-competitive agreements and abuse of dominance positions) and Part 3 (mergers and acquisitions) of the Competition Act to the acquisition by the Minister, or the transfer by the Minister to the Minister’s nominee, of shares in Anglo Irish Bank.

It also disapplies section 7 of the Credit Institutions Act with respect to the acquisition by the Minister, or the transfer by the Minister to the Minister’s nominee, of shares in Anglo Irish Bank. In other words, the Anglo Act excludes any competitive effects analysis in respect of an acquisition by the Minister or the Minister’s nominees involving a bank covered by the Credit Institutions Act.

The acquisition of Anglo by the Minister has, therefore, completely put aside the competition rules. This may set a precedent if the Minister were to proceed to recapitalise the two major Irish banks, AIB and Bank of Ireland (as already announced), or to nationalise them in a similar manner.

It is possible that further acquisitions by the Minister or the Minister’s nominees of Irish banks might give rise to a concentration with a Community dimension under the Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings (the “ECMR”). Such acquisitions must be notified to the European Commission even if the legislation enabling them disapplies the Competition Act.

In this regard, further acquisitions by the Minister or the Minister’s nominees that give rise to a concentration under the ECMR are likely to be in conflict with the application of certain provisions of the ECMR concerning the referral of a concentration back to a competent body of a Member State.

6. Conclusion

The Authority notes that measures put in place by the Irish Government to ensure the stability of the financial services sector are capable of putting aside domestic competition rules.
JAPAN

Challenges for Competition Policy in Periods of Retrenchment

1. Introduction

During the period of economic downturn triggered by the financial crisis, there is the possibility of growing pressure on competition policy to loosen enforcement to prioritize the economic recovery.

On the other hand, based on the experience of the Fair Trade Commission (JFTC) during the period of the last financial and economic crisis, while it may be possible to take short-term measures, such as speeding up merger investigations for failing or distressed companies that satisfy certain conditions, it is inadequate to allow an anticompetitive market structure that is inconsistent with the principle of competition law because it will cause serious negative harm to the economy in the medium and long term. It is necessary to steadily implement and enforce competition law by taking into consideration how the medium and long term effect on competition is affected by the structural change caused by the intensification and the concentration of industries as a result of the financial and economic crisis.

The following sections describe the financial crisis in Japan in the 1990s and policy responses to it and introduce competition policy developments during the same period.

2. Responses to the financial and economic crisis in Japan

2.1 The situation of the financial and economic crisis in the 1990s and the outline of the government policy response

The financial crisis in the 1990s and the current financial crisis evolved in a similar fashion, as is explained as follows:

- Irresponsible lending had been widespread prior to both crises, on the assumption that real estate prices would continue to go up.
- The financial market turmoil was triggered by the decline in real estate prices.
- The adverse effect of the market turmoil spilled over to the real economy.
- The turmoil resulted in a system-wide financial crisis, thereby necessitating public intervention by governments and central banks.

In light of the above-mentioned points, this section introduces (1) the background which necessitated the injection of public funds into the financial institutions, and (2) the process of the development of such a funding scheme.
2.1.1 After the bubble burst (first half of the 1990s): burden sharing by private financial institutions and its limits

In the early 1990s, failing financial institutions were bailed out in the form of acquisitions or business transfers and by finding rescuing financial institutions on a case-by-case basis. During this period, as rescuing and other relevant financial institutions still had some financial strength to help other financial institutions, all the debts including the deposits of failing institutions were protected in every case by making them assumed by the rescuing financial institutions through the combination of (a) financial aid (up to the amount covered by the payoff system) from the Deposit Insurance Corporation (DIC) and (b) loss sharing by the relevant financial institutions.

However, in the mid 1990s, as the number of bank failures increased, it became difficult not only to find rescuing institutions but also to ask other relevant institutions for assistance. The Japanese government decided, as a limited measure for five years, to protect all the debts, including the deposits of the failing institutions, by increasing the amount of financial assistance from the DIC and requiring financial institutions to take on an additional insurance premium as a funding source (published in June 1995 and implemented in June 1996). At around the same time, the Resolution and Collection Bank (RCB) was established as a permanent institution to assume the assets and the debts of the failing credit associations with the aim of facilitating their smooth resolutions.

2.1.2 The progress of the financial crisis (second half of the 1990s): the spillover of the crisis to large financial institutions and the injection of public funds

The successive failure of Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities in November 1997 provided momentum for policy measures taken in February 1998, such as (1) defining the role of the RCB as the general institution for bailing out (not only failing credit associations but also) all types of failing deposit-taking institutions, including banks, and preparing the framework of utilizing public funds to deal with the failure of deposit-taking institutions (the size of the fund started with 17 trillion JPY); (2) introducing a scheme for funding the shortage of capital of financial institutions by using public funds (the size of the fund started with 13 trillion JPY).

However, in the middle of 1998, the necessity of further improvement of the regulatory framework became clear as the financial trouble of the Long-Term Credit Bank emerged. Thus, in October 1998, (1) a system for maintaining the financial operation of the failed institutions to search for acquirers afterwards [Special Public Management (temporary nationalization), Financial Reorganization Administrators System, and Bridge Bank System] and (2) a system for purchasing non-performing loans from healthier financial institutions were established, and at the same time, (3) the scheme for financing the shortage of the capital of banks was improved and expanded (the size of the fund became 25 trillion JPY).

2.1.3 The promotion of structural reform and the recovery from the economic slump (after 2000): the development of a permanent framework

By utilizing the framework that had been improved step-by-step, failing financial institutions such as the Long-Term Credit Bank and the Nippon Credit Bank were temporarily acquired by the government. Furthermore, in 1999, large-scale capital injection from public funds (about 7.5 trillion JPY to the 15 large banks) was executed and the financial crisis gradually came to an end through the progress of restructuring.

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1 During the period between the announcement and the implementation of these measures, public funds up to JPY 685 billion were separately required to solve the trouble of housing loan companies, which became the first large-scale bailout through public funds and raised a big political issue.
large financial institutions as well as the disposal of non-performing loans based on the so-called the Program for Financial Revival.

Along with the calming down of the financial crisis, the measure of protecting full deposits was partially abolished (through lifting the freeze on the payoff for time and savings deposits), and after confirming the disappearance of anxiety over the financial system, the payoff system was fully implemented. (Payment and settlement deposits satisfying certain conditions are fully protected and other deposits are protected up to a maximum principal of 10 million JPY plus accrued interest thereon.)

At the same time, a system to deal with the failures of financial institutions was developed by making the measures introduced gradually during the 1990s (Financial Reorganization Administrators System and Bridge Bank System) permanent. In addition, based on the experience of tackling the anxiety over the financial system since the 1990s, the existing systems were restructured and the following three measures were institutionalized to address the systemic risk: (1) capital injections by public funds to the financial institutions that run short on capital, (2) protection of all debts including deposits by financial assistance exceeding the pay-out cost in the process of the bailing out of failing institutions, and (3) temporary nationalization by the authorization of Special Crisis Management.

These measures to address the systemic risk have institutionalized beforehand financial assistance from public funds based on a decision by the government under strict requirements2.

Under these permanent frameworks, public funds were used to recapitalize Resona Bank in June 2003 and Ashikaga Bank became temporary nationalized by the start of the Special Crisis Management program in November 2003, which contributed to dispel anxiety over the financial system and the recovery of the credibility of the market.

2.2 Lessons learned from Japan’s experience regarding financial sector regulations

As explained above, Japan overcame its financial crisis by using as much as 100 trillion JPY, that is, about 20% of the GDP, to deal with the non-performing loans after the bubble burst.

The bitter experience of Japan in the 1990s suggests several useful lessons, as below.

The first lesson is that prompt and accurate recognition of losses is essential. In the early 1990s, Japan did not have effective frameworks in place for disclosure and provisioning with respect to non-performing loans. This gave financial firms incentives to postpone the disposal of their non-performing loans, and the country plunged into a negative spiral of credit crunch and deterioration of the real economy.

The second lesson is that toxic assets need to be taken off the balance sheet. This is crucial in order to break the negative spiral. If a financial firm were to undertake provisioning only and leave the assets on its balance sheet, it would be difficult to restore full market confidence as additional losses on those assets could be incurred later.

Third, undercapitalization of financial firms needs to be addressed quickly, by injecting public funds if necessary. Prompt and sufficient recapitalization is needed if a financial firm becomes undercapitalized

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2 To be more precise, in order to implement exceptional measures to deal with the systemic risk, it is necessary for the Prime Minister to “deem that an extremely serious threat is posed to the maintenance of financial stability in Japan or a region where financial institutions are conducting operations”, following discussions by the Financial System Management Council. (The council is chaired by the Prime Minister and consists of the Chief Cabinet Secretary, the Minister for Financial Services, the Commissioner of the Financial Services Agency, the Minister of Finance, and the Governor of the Bank of Japan.)
as a result of the disposal of bad assets. In cases where a sufficient amount of capital cannot be raised on a market basis, recapitalization with public funds is effective as a final safety net.

Fourth, exceptional measures, such as a blanket guarantee of bank deposits and the temporary nationalization of troubled banks can be options in times of serious crises.

The fifth lesson is that short-term measures and a re-design of the regulatory framework in the medium-term need to be implemented simultaneously and in a balanced manner. If the policies lean too much toward crisis management, they could cause moral hazard or distort the system in the long run. On the other hand, the hasty implementation of medium-term measures could rather exacerbate the situation and make crisis management even more difficult.

3. Competition policy developments under the financial crisis from the 1990s onward

As explained in 2 above, the burst of the economic bubble in the 1990s and the financial and economic crisis afterwards caused serious problems. To maintain the financial system, the Japanese government took exceptional measures, such as the injection of public funds, the full protection of bank deposits and the temporary nationalization of troubled banks.

On the other hand, from the perspective of competition policy, special measures, such as more lenient merger control for failed financial institutions, were not taken, nor was the enforcement standard of competition law applied to other distressed industries and firms relaxed when the financial crisis spilled over into the real economy and caused a long-term economic slump. Instead, during the same period, based on mid- and long-term perspectives, e.g. market liberalizations, regulatory reforms and structural reforms, competition policy as a whole tended to be strengthened.

3.1 Immediately after the economic bubble burst (in the early 1990s)

In the early 1990s, the Japanese economy faced the burst of the bubble, while issues such as the gap between the nation’s economic power and the public’s actual feeling about their lives, the imbalance of external trade and Japan’s market system became problems. Therefore, it became an important issue to seek continuous economic growth supported by domestic demand, to further open up Japan’s market and to improve people’s daily lives based on the perspective of giving higher priority to ordinary citizens and consumers. Against this background, expectations and demands grew for the role of competition policy, whose objects are to advance fair and free competition for domestic and foreign entrepreneurs, to improve competitive conditions so that each entrepreneur can do a lively business activity based on his/her independent decision-making and creative ingenuities and to ensure the sound development of Japan’s economy and the interest of consumers.

3.1.1 Structural reform in the distribution sector

From the perspective of further opening up Japan's market, the Structural Impediments Initiative (SII) talks between the U.S. and Japanese governments, which had commenced in 1989, gave rise to wide-ranging debates concerning Japan's distribution system, trade practices and so on, and had a major influence on the formation of competition policy at that time.

In parallel with these talks, the Japan Fair Trade Commission (JFTC) held meetings of the “Review Committee Concerning Distribution Systems and Business Practices, etc. and Competition Policy”, and it examined the actual situation of Japan's distribution systems and business practices, evaluated them from the viewpoint of competition policy, and explored the direction of actions to be taken. The JFTC and the Review Committee put together its report in June 1990. And based on a proposal from the Committee, the

The guidelines attempted to comprehensively and concretely clarify the contents of the regulations stipulated in the Antimonopoly Act (AMA) and the enforcement policy of the JFTC, covering every aspect of distribution systems and business practices, including production materials and capital goods, and based on the reality of business transactions prevailing in Japan. The guidelines were especially noteworthy because they aimed to prevent violations, improve the transparency of law enforcement and promote domestic and international understanding towards competition policy in Japan. In response to the publication of the guidelines and based on their content, Japanese industries voluntarily began to change their business practices to make them more agreeable to the guidelines.

In addition, the provisions of the AMA do not apply to resale price maintenance on “a commodity, which is designated by the JFTC” and “the work” under specific conditions (previously Article 24-2 and currently Paragraph 1 and 4 of Article 23). Based on the provisions, in 1989 the number of commodities designated by the JFTC was 26 under certain general non-prescription drugs and 14 under certain cosmetics with a retail price of less than 1,000 Japanese Yen. However, in order to meet the growing need to review the designated commodities from the viewpoint of regulatory reform, in April 1992, the JFTC announced that it would completely review and phase out the designation of commodities. According to this policy, the JFTC gradually limited the scope of the designated commodities, and as a result, there has been no commodity designated by the JFTC since April 1997.

3.1.2 Strengthening deterrence against violations of the AMA

In the early 1990s, the JFTC took actions to introduce more effective deterrents to prevent violations. In connection with these efforts, the amended AMA, including expansion of the surcharge rate, was approved in April 1991, and another amended AMA calling for heavier criminal penalties was approved in December 1992. As a result, the AMA amendments increased the surcharge rate (from 1.5% of sales to 6%) and increased the criminal penalties for a juridical person in the case of double punishment (fine for certain AMA violations up to 100 million yen).

By amplifying and strengthening investigative capacities against violations, the number of JFTC staff in the investigation department increased dramatically from 154 in FY 1990 to 220 in FY 1995 (an increase of 66 staff). This effort resulted in a dramatic increase in the number of legal measures against violations of the AMA; from an average 9.6 cases a year between FY 1986 and FY 1990 to an average 30.2 cases a year between FY 1991 and FY 1995.

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3 In June 1990, the JFTC published the “Policy on Criminal Accusations Concerning the AMA violations” and adopted an active policy to apply criminal accusation to violations which a) constitute serious cases that are likely to have a widespread influence on the national economy, including price-fixing cartels and bid-rigging or b) involve firms or industries that are repeat offenders and for which the administrative measures of the JFTC are not considered to be sufficient to meet the aims of the AMA.

4 The SII final report (June 1990) suggested as a measure against exclusive trade practices, etc that Japan should expand and strengthen the investigation capacities of the JFTC for rigorous enforcement. The Diet resolution accompanying the enactment of the 1991 amended AMA, which would increase the surcharge rate, also required implementing necessary measures to expand the organization and increase the JFTC staff (March 1991 in the Committee on Commerce and Industry, House of Representatives).
### Table 1. (Appendix) Trends in the number of legal measures (from FY 1986 to FY 1995)

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<td>34</td>
<td>31</td>
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Note: Orders Without Recommendation

### 3.2 Progress of the financial crisis (in the late 1990s)

While the financial crisis was aggravated as the problem of non-performing loans besetting financial institutions caused by the burst of the bubble worsened and made some financial institutions run into financial difficulties, the yen’s appreciation exposed the price differential within and outside the country as well as urged enterprises to shift overseas, which resulted in the hollowing-out of industry and employment uncertainty. Under these circumstances, the need to reform the economic structure was stressed more for the purpose of further opening up Japan’s market at home and abroad.

#### 3.2.1 Efforts for regulatory reform

The JFTC had long been conducting mid- and long-term reviews of the government’s regulatory system from a perspective of competition policy. “The Deregulation Action Plan” decided by the Cabinet on March 31, 1995, stated that “the government shall actively promote competition policy along with deregulation to make the Japanese market more open by enhancing fair and free competition in the Japanese market”. The Government of Japan places these efforts as the top priority. To make the Japanese economy and society internationally open and based on the principles of self-responsibility and market principles through fundamental structural reform and to change government administration from one that emphasizes ex-ante regulation to one that employs ex-post facto checks, the deregulation of entry or price regulation was promoted and implemented in sectors such as logistics and distribution, energy, telecommunications, financial services, passenger transportation, etc. after the action plan was launched.

To promote fair competition in the sectors where regulatory reform was implemented, the JFTC published, in cooperation with relevant ministries, guidelines concerning administration that take into consideration consistency between the AMA and the relevant business laws. The JFTC published the “Guidelines Concerning Appropriate Electric Power Dealings” in 1999 with the Ministry of Economy, Trade and Industry (METI), the “Guidelines Concerning Appropriate Natural Gas Dealings” in 2000 with the METI and the “Guidelines for Promotion of Competition Policy in the Telecommunications Business Field” in 2001 with the Ministry of Public Management, Home Affairs, Posts and Telecommunications (MPHPT).

#### 3.2.2 Review of Exemptions

One of the significant achievements in competition policy of the late 1990s is the substantial progress made in reviewing exemption systems under the AMA. The JFTC considered positively the review of exemptions along with the promotion of deregulation by the government as a whole based on “the Deregulation Action Plan”, “Revision of the Deregulation Action Plan” (Cabinet decision, March 1996) and “Three-Year Deregulation Plan” (Cabinet decision, March 1998), and requested the relevant ministries concerned to review the exemption systems. As a result, three legislations to revise the exemption system were taken in 1997, 1999 (abolishing the depression cartel system and the rationalization cartel system)
and 2000, which led to the reduction of the number of exemptions from 89 systems under 30 laws as of the end of March 1996, to 21 systems under 15 laws as of the end of March 2001 and up to the present.

3.2.3 Improvement of merger control regulations

The JFTC has examined business combination (M&A) cases based on provisions in Chapter 4 of the AMA. Since the late 1990s, with the increase of large-scale business combinations due to rapid changes in the economic environment, such as the globalization of business activities, the JFTC proceeded with the improvement and the appropriate implementation of regulations on business combinations to secure a competitive market structure in the Japanese market.

The 1998 amendment of the AMA (Review of regulations on M&As outside of Japan, reduction of the scope of reporting and notification requirements)

To review the regulations on business combinations from the viewpoints of their purpose, reducing the burdens on companies, and ensuring the international harmonization of the system, the JFTC considered an amendment bill of the AMA through the establishment of the “Subcommittee for Review of Regulations on Business Combination”. The bill, which aimed to reduce the scope of reporting and notification requirements regarding mergers and stockholding and to improve examination procedures, was enacted on May 22, 1998, promulgated on May 29, 1998, and came into force on January 1, 1999. (Some parts of the enactment were put into force immediately upon promulgation.)

The publication of Merger Guidelines (1998)

Prior to the effectuation of the amended AMA on January 1, 1999, the JFTC had newly formulated and published the “Guidelines for Interpretation on the Stipulation that ‘The Effect May Be Substantially to Restrain Competition in a Particular Field of Trade’ Concerning M&As” in December 1998, in order to improve transparency and predictability regarding the implementation of regulations on business combinations such as stockholdings and mergers, etc.

3.3 Promotion of Structural Reform (Koizumi’s Reforms since 2000)

Since 2000, major changes have been taking place in the environment surrounding the economy and society, including the globalization of the economy and remarkable technological innovation. The Koizumi Cabinet advocating “economic structural reform” was established in 2001. In his general-policy speech on May 7, 2001, Japanese Prime Minister Junichiro Koizumi regarded “strengthening the structure of the JFTC, which should serve as the guardian of the market, thereby establishing competition policies appropriate for the 21st century” as an important pillar of economic structural reform for the revitalization of the Japanese economy. This speech led to further proactive development of competition policy.

3.3.1 Establishment of competition policy appropriate for the 21st century

As noted above, the JFTC drew up the “Grand Design for Competition Policy for the 21st century – making it well functioning as the guardian of the market” in June 2001, which consisted of the following 3 points: “Law Enforcement consistent with the Trend of Structural Reform”, “Promotion of a Competitive Society based on Rules” and “Proactive Creation of Competitive Environments”. The JFTC held meetings convened under ”The Committee Considering Competition Policy Appropriate for the 21st century” comprised of outside experts to consider the role of competition policy appropriate for the 21st century, as well as the organizations and functions needed to implement such a policy. The committee compiled the results of its examination as a recommendation on ”The Role of Competition Policy and the Japan Fair Trade Commission for the 21st Century”, including the review of penalties, etc.
3.3.2 Strengthening and Amendment of the AMA

In light of the recommendation discussed above, etc, beginning in October 2002, the JFTC held a Study Group on the Antimonopoly Act consisting of academic experts, etc, regarding the review of the penalty system and regulations on monopolies and oligopolies, published the study group’s report and continued with the study of the amendment bill of the AMA. The bill was passed in April 2005 and the amended AMA was put into force from January 2006 to break away from the structure of bid-rigging and conformist behavior and to establish a competition policy suitable for the 21st century. The main amendments were (a) revision of the surcharge system, (b) introduction of a leniency system, (c) introduction of compulsory measures for criminal investigations, and (d) revision of hearing procedures. The amended AMA is being implemented smoothly, and its expected effects are steadily being realized.

3.3.3 Strengthening and amplifying the capacity of the JFTC

In light of the general speech by Japanese Prime Minister Koizumi, in which he said, “we will strengthen the structure of the JFTC, which should serve as the guardian of the market”, the move towards strengthening the function of the JFTC was spurred. Trends in the number of officials in the General Secretariat of the JFTC are as follows. Despite trends for slimming down the administration under overall administrative and financial reform, the expansion of the capacity of the JFTC shows remarkable evidence of competition policy’s standing among government policies.

Table 2. (Appendix) Trends in the number of officials in the General Secretariat of the JFTC

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<td>+31</td>
<td>+28</td>
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Note: The number in each parenthesis means staff of the investigation bureau.

3.3.4 Measures under the efforts for industrial revitalization

In order to revitalize the economic resources of the enterprises with excessive debts and to solve the issue of excessive supply structures, the Government of Japan adopted the “Basic Policy for Corporate and Industrial Revitalization” (December 19, 2002, Strategic Headquarters for Industrial Revival and Employment Measures) and decided to adopt all consistent policy measures with regard to corporate and industrial revitalization. This policy provides that the JFTC should adopt special guidelines for the cases that would be the objects of the Law on Special Measures for Industrial Revitalization and make efforts to accelerate the merger review on such cases with the cooperation of the concerned entrepreneurs.

Based on the fact that corporate and industrial revitalization was the current topic of importance, and that a quick response was required, on April 9, 2003, the JFTC published the “Guidelines for Merger Investigations on Cases concerning Corporate and Industrial Revitalization” in order to further accelerate its review, with the cooperation of the firms concerned, on mergers related to projects that will become the subject of the revised Law on Special Measures for Industrial Revitalization. Furthermore, the JFTC organized a special team within the relevant division in charge and made efforts to improve the capacity.

As to the leniency program, there have been 179 applications as of the end of March 2007. Cases upon which the JFTC took measures include those based on self-reporting information sources. In addition, regarding criminal cases, the JFTC has filed criminal accusations with the Prosecutor General in 4 cases as a result of investigations conducted by the newly established Criminal Investigation Department.
for faster review of cases concerning projects that would become the subject of the revised Law on Special Measures for Industrial Revitalization. As a result, for example, while the average number of days required for Phase I review on ordinary cases in FY 2004 was 22.3, the average number of days for Phase I review on the cases that were the object of the revised Law on Special Measures for Industrial Revitalization was 17.3.

4. What competition policy should be like during difficult economic times based on Japan’s past experience

In facing a financial and economic crisis, the pressures to relax the enforcement of competition law tend to grow stronger. However, it is necessary to avoid wherever possible such policy measures that have the likelihood to change the market structure into an anti-competitive one in the long-term. The General Guidelines for Positive Adjustment Policy (PAP)\(^6\) approved by the OECD Council in June 1978 has suggested principles of structural adjustments as follows: (1) adjustments should rely on the market mechanism as much as possible; and where government finds it necessary to intervene in industries (2) actions should be temporary and phased-out; (3) incentives for improved management practices should be provided by ensuring sufficient domestic and international competition; (4) costs should be made as evident as possible, etc.

The Positive Adjustment Policy affected policy responses to the past economic crisis in Japan. During the structural depression after the oil crises, the so-called Structurally Depressed Industry laws, that is, the Law on Temporary Measures for Stabilization of Specified Depressed Industries (1978), the Law on Temporary Measures for the Structural Improvement of Specified Industries (1983) and the Law on Temporary Measures to Facilitate Industrial Structural Adjustment (1987) were drafted. In the process of the legislation of these acts, there was, at first, a strong tendency of requiring government intervention from the viewpoint of industrial policy, such as considering or implementing instructed cartels by the government and exemptions to the AMA. However, because of the JFTC’s actions and the influence of so-called “Positive Adjustment Policy” approved by the OECD, these laws ended up substantially taking into consideration competition policy, which is shown by the following facts: (1) the JFTC’s agreement was required even if cartels instructed by the relevant Ministers were allowed; (2) in the later legislation of the above laws, in order to implement business alliances within the framework of the AMA, a coordination scheme was drawn up between the relevant minister and the JFTC regarding the relevant minister’s approval of the alliances; (3) cartels instructed by the relevant ministers were not allowed in the 1987 law.

Besides, during the economic and financial crisis of the 1990s after the economic bubble burst, as explained in 3 above, the institution of the competition authority and the enforcement of competition law were strengthened in Japan. Under the serious financial and economic crisis, while measures were taken to make the review period shorter for certain business combinations that had little possibility of raising competitive concerns among the cases to which the Law on Special Measures for Industrial Revitalization, whose objective is to respond to the issue of excessive debt and the issue of excessive supply structures, was applicable, no special measures were taken for particular industries and enforcement standards of the AMA were not relaxed. On the other hand, the number of exempted cartels to the AMA was substantially reduced during that period and the function of the AMA, as well as the role of the JFTC, were strengthened.

Therefore, taking anticompetitive measures as a way to counter a financial and economic crisis should be avoided as far as possible because there is a possibility that such measures may negatively affect the economy in the mid- and long-term, even if they are taken only for a short period. In fact, the promotion

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\(^6\) Annex II to the Communiqué of 1978, Meeting of the OECD Council at Ministerial Level in June 1978 Communiqué.
of competition from the perspective of the mid- and long-term can lead to positive effects on economic growth. It is believed that cutting waste in the economy and increasing efficiency through competition can enhance productivity and contribute to economic growth.

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7 The Structural Reform Evaluation Report published by the Cabinet Office in 2006 analyzed the connection between the progress of regulatory reform and the productivity growth rate over 7 years from 1995 to 2002, including the age of the 1990s financial and economic crisis. This report concluded that the correlation between progress in regulatory reform and productivity growth is statistically significant. The progress of regulatory reform, such as entry/exist control, is closely related to a competitive environment of the market. It would be suggested that improving regulatory reform has the possibility to lead to increasing productivity.
KOREA

The Role of Competition Policy in Financial Sector Rescue and Restructuring

1. Introduction

Korea carried out a full-fledged restructuring in the financial sector as a way to overcome the financial crisis that struck Asia in 1997. But given that its financial restructuring initiative was taken as part of conditions to receive IMF emergency rescue funds, it was inevitable that the Korean government had certain limits in exercising its discretion.

This paper will overview the specific characteristics and substance of Korea's financial restructuring carried out in the wake of the Asian financial crisis and then assess its impact on the Korean financial market from a competition policy perspective.

2. Characteristics of Financial Restructuring of Korea

In Korea, financial restructuring was carried out in an unprecedentedly swift manner, upon the request of the IMF and with the firm commitment and thorough planning of the Korean government. On December 3rd, 1997, Korea signed an MOU with the IMF for emergency loans and thereafter, over a total six times until July 24th, 1998, Korea sent the Letter of Intent to the IMF. As a result, it took just 7 months for Korea to set up a legal and institutional framework to proceed with financial restructuring and begin to carry out a sweeping clean-up of ailing merchant banking corporations and commercial banks and disposal of their bad assets.

Comparing with Thailand and Indonesia, which were infused with IMF emergency funds in sometime around 2007 as well, Korea showed distinctive characteristics in going about financial restructuring.

First, Korea is said to have met the following requirements that the IMF reckoned are essential to a successful financial restructuring; a comprehensive approach, prompt action, firm exit policies and designating a lead agency. All things considered, the success of Korea’s financial restructuring is attributable to favorable internal and external circumstances.

That is, on the external front, the insurmountable pressure was at work that Korea’s failure to comply with measures set out in the Letter of Intent would lead to the suspension of IMF loans. On the internal front, there was a public consensus that financial restructuring should be carried out rapidly for Korea to fast escape from the economic crisis.

Second, Korea was faster in establishing the necessary legal and institutional groundwork for restructuring as it had been pursuing its own financial reform way before the crisis. In fact, before the crisis hit, bills for financial reform had already been submitted before the National Assembly. The proposals included several measures. First, the government would funnel badly needed capital to banks. Second, powerful restructuring would be launched, with the goal of completion of due diligence on merchant

banking corporations by the end of January 1998, on banks by the end of March 1998 and on other financial institutions by the end of June 1998. And lastly, the Non-performing Asset Management Fund would be greatly expanded to launch the Korea Asset Management Corporation (KAMCO) so that in a short time period, the KAMCO would buy if possible, all non-performing assets from financial institutions.

3. Details of Restructuring Initiative

In consultation with the IMF, the Korean government first went about liquidating merchant banking corporations that had been directly involved in triggering the financial crisis for their role of financing foreign exchange, and then completed liquidation of failing banks by September 1998. Since then, non-banking financial institutions except for merchant banking corporations were also subject to restructuring. This initiative led to a 20% decrease in the number of financial institutions from 436 in late 1997 to 348 in late July 1999.

3.1 Restructuring of the Banking Sector

The restructuring of the banking sector was begun with the preparation work in the Q2 of 1998 and carried out intensively from the Q3 of the year. This led to reduction of the number of banks from 33 in late 1997 to 23 in late 1999. The details of the restructuring are as follows.

For the first time, on June 29th 1998, measures to eliminate five non-performing banks that were Donghwa, Daedong, Dongnam, Gyeonggi, and Chungcheong were taken through P&A (the Purchase of assets & Assumption of liabilities). Under P&A, the government-designated bank buys debts and high-quality assets only, with non-performing assets bought by the KAMCO.

Along with the exit of the 5 banks, the banking sector restructuring was carried out in various forms including M&As, foreign investment promotion and capital increase. All in all, five bank M&As in the wake of the financial crisis took place as of the end of 1999. The Korea Commercial Bank and the Hanil Bank first agreed to merge in July 1998, followed by an agreement between the Hana Bank and the Boram Bank, the one between the Kookmin Bank and the Korea Long Term Credit Bank, the one between the Chohung Bank and the Bank of Chung Buk, and again the one between the Kookmin Bank and the Kangwon Bank. These succeeding M&As in the banking sector took place in 22 years since the Seoul Bank and the Korea Trust Bank merged back in 1976. The five M&As of course took place as part of self-help efforts by ailing banks, but to some extent, they were the result of the government’s intent. The government demanded intensive restructuring of the merging banks in exchange for purchasing their non-performing bonds as a priority. In addition, the government tried to ensure that banks would recover financial soundness with capital input from the Korea Deposit Insurance Corporation.

3.2 Restructuring of the Non-banking Financial Sector (merchant banking, lease, securities, insurance, trust and etc.)

Restructuring of the non-banking financial sector took place as follows. Between the end of 1997 and July of 1999, the government-initiated restructuring efforts in this sector were made on a total 42 institutions in the form of M&As, P&A and liquidation. Among them, 38 institutions ended up going under through liquidation and P&A. The higher number of liquidation in the non-banking sector than that of the banking sector can be attributed to the lower cost of liquidation, the less impact on the national economy and their worse financial condition.

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(2000), Reflection on the Korean Economy of 1999 and Tasks Ahead, Samsung Economic Research Institute
The M&As in the non-banking financial sector took place as follows. First, in August 1998, Hannam Securities was acquired by Hyundai Securities, and in following November, Korea Guarantee Insurance and Hankuk Fidelity & Surety merged to become Seoul Guarantee Insurance. Then, in February 1999, Hyundai Merchant Bank was acquired by Kangwon Bank, and in the following October, LG Merchant Bank was bought by LG Securities.

Table 3. Financial Restructuring taken after Financial Crisis (as of late July 1999)

<table>
<thead>
<tr>
<th>Category</th>
<th>No. of Entities</th>
<th>Liquidation</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>33</td>
<td>10</td>
<td>30.3</td>
</tr>
<tr>
<td>Merchant Banks</td>
<td>30</td>
<td>19</td>
<td>63.3</td>
</tr>
<tr>
<td>Securities</td>
<td>36</td>
<td>6</td>
<td>16.7</td>
</tr>
<tr>
<td>Insurance</td>
<td>50</td>
<td>5</td>
<td>10.0</td>
</tr>
<tr>
<td>Trust</td>
<td>31</td>
<td>7</td>
<td>22.6</td>
</tr>
<tr>
<td>Lease</td>
<td>25</td>
<td>5</td>
<td>20.0</td>
</tr>
</tbody>
</table>

4. Answers to the Secretariat Questions

4.1 Should competition law be set aside in the financial sector during a systemic crisis, on public interest or other grounds? If so, how should this be done?

The Korea Fair Trade Commission, in principle, does not have any dissenting opinions on the idea that even under a systemic crisis, competition law should be applied to the financial sector. Yet, we deem that emergency measures initiated by the government in times of a systemic crisis, for the sake of public interest and stability of the financial system, may be exempted from competition law. This is because that these types of emergency measures are usually taken through the enactment/amendment of laws and regulations, and Article 58 of the Monopoly Regulation and Fair Trade Act stipulates that legitimate conduct pursuant to other laws may be exempted from competition law.

Meanwhile, the KFTC makes it a rule to review laws and regulations to be enacted or amended by other regulatory authorities through consultation with the concerned authorities regarding their potential anti-competitive effect. This statutory review is also applied to the enactment/amendment of laws and regulations drafted to overcome an economic crisis. Therefore, the KFTC is entitled to review, regarding the anti-competitive effect, the laws and regulations that would serve as a legal groundwork for emergency measures to overcome a crisis, prior to their enactment or amendment.

4.2 How should competition agencies apply general competition policy rules about mergers, anticompetitive conduct and state aid during a crisis? Is it practicable to apply failing firm doctrines to mergers as crisis actions?

As stated in the Question 1, the KFTC does not dispute the idea that even during a systemic crisis, the financial sector should not be exempted from competition law in principle, except for some cases.

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For example, the KFTC exempted from its merger review the 5 bank M&As under the government initiative in the wake of the 1997 financial crisis as it deemed them as legitimate conduct pursuant to other relevant laws. That is, the KFTC saw the mergers as legitimate acts under the control of the Financial Supervisory Commission pursuant to the *Financial Industry Structural Improvement Act*, an emergency measure designed to overcome the 1997 crisis. Still, albeit an afterthought, the KFTC reckons that its review would not have determined the M&As as seriously anticompetitive, given the existence of multiple competing enterprises in the relevant market at that time.

With respect to merger review, Article 7 (2) 2 of the MRFTA explicitly states on “the merger with a non-viable company,” which means the MRFTA has already incorporated a failing firm doctrine. In addition, as the provision above is applied to all industries including financial one, there is no dispute on the use of failing firm doctrine in reviewing bank mergers. However, to date, failing firm doctrine has never been employed to authorization of mergers between financial institutions.

Regarding cartel enforcement, under Article 19 (2) 3 of the MRFTA stipulates that cartel activities may be sanctioned that have been pursued to overcome an economic downturn. However, no cartels in the financial industry have been authorized for such purpose to date.

Meanwhile, financial aid as part of bailout plan for financial institutions including banks is usually regarded as a practice acceptable both at home and abroad with the following economic and legal grounds. First, bankruptcy of banks could trigger a chain-reaction bankruptcy leading to a breakdown of the entire the financial system. Second, the breakdown of the financial system would have a far-flung effect over Main Street. Lastly, under the deposit insurance system (or in the case of central bank lending), the government (or central bank) could directly suffer from a bank run.

4.3 *What lessons may be learned from how competition authorities have participated in responses to the recent crises and to previous events such as the Asian financial crisis of 2007? Are there any experiences from past financial crises in which measures for emergency response to the crisis in the short term, like mega mergers in the financial and other business sectors, caused greater harm to the competition in the medium and long term?*

The answer to this question will be dealt in details in the next chapter.

5. *Changes in the Korean Financial Market after the Asian Financial Crisis in 1997 and its Implications thereafter*

5.1 *Bank Consolidation and Growing Market Concentration*

With restructuring drive gripping through the financial industry, banks rushed to consolidate their operations, thereby leading to a high market concentration level. In fact, when you look at the average asset size of Korean banks, as of late 1997 when the financial crisis just struck, the figure for nationwide banks recorded a mere 30 trillion 194.6 billion won. However, the figure continued to increase thereafter to mark 89 trillion 237.5 billion won in late 2003, almost a triple that of late 1997.
Table 4. Changes in Bank Asset Size
(Unit: one billion Korean won)

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Banks</th>
<th>Total Asset</th>
<th>Average Asset per Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>16</td>
<td>483,113</td>
<td>30,194</td>
</tr>
<tr>
<td>1999</td>
<td>11</td>
<td>506,786</td>
<td>46,071</td>
</tr>
<tr>
<td>2001</td>
<td>9</td>
<td>494,307</td>
<td>54,923</td>
</tr>
<tr>
<td>2003</td>
<td>8</td>
<td>713,931</td>
<td>89,237</td>
</tr>
</tbody>
</table>

* Source: 「Bank Management Statistics」, Financial Supervisory Service, each year's edition

Banks’ growing asset size and their consolidation raised the market concentration level in the banking industry. As seen in the table below, the combined asset of top 3 banks was just 32.5% as of 1997 whereas in late 2003, the figure notably soared to 57.9%. Especially, the CR1, referring the level of market concentration of top 1 bank, nearly tripled during the period from 11.8% to 30.5%

Table 5. Changes in Market Concentration Level in Banking Industry
(Unit : %)

<table>
<thead>
<tr>
<th></th>
<th>Asset</th>
<th>1997</th>
<th>1999</th>
<th>2001</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CR1</td>
<td>11.8</td>
<td>16.4</td>
<td>24.9</td>
<td>30.5</td>
</tr>
<tr>
<td></td>
<td>CR3</td>
<td>32.5</td>
<td>43.4</td>
<td>51.1</td>
<td>57.9</td>
</tr>
<tr>
<td>Withholding</td>
<td>CR1</td>
<td>10.6</td>
<td>16.3</td>
<td>25.8</td>
<td>30.2</td>
</tr>
<tr>
<td></td>
<td>CR3</td>
<td>31.5</td>
<td>43.9</td>
<td>52.3</td>
<td>59.3</td>
</tr>
<tr>
<td>Loans</td>
<td>CR1</td>
<td>11.3</td>
<td>17.1</td>
<td>35.2</td>
<td>32.3</td>
</tr>
<tr>
<td></td>
<td>CR3</td>
<td>33.0</td>
<td>47.4</td>
<td>61.6</td>
<td>60.5</td>
</tr>
</tbody>
</table>

* Source: 「Bank Management Statistics」, Financial Supervisory Service, each year’s edition

5.2 Impact of Bank Consolidation on Efficiency and System Stabilization

5.2.1 Efficiency


Researchers with the Institute for Monetary and Economic Research of the Bank of Korea (2006), The Effect of Bank Consolidation and Increased Market Concentration on Bank Efficiency, BOK Institute Working Papers No.274
The empirical analysis noted that when it comes to cost efficiency, it has been improved in the wake of consolidation or integration through holding company system, but a direct cause-effect relationship has yet to be found. In other words, in both models, which were employed to indicate cost efficiency, the one using “labor cost/total asset” ratio and the one using “operating cost/total asset” ratio, mergers or integration through holding company system enhanced cost efficiency. But this is the result without controlling the net period effect in both models. In fact, with the net period effect controlled using year dummies, there was no improvement in cost efficiency made by mergers in both models. What this means is that there were factors other than mergers which raised cost efficiency of the banking industry in Korea.

In contrast, mergers or integration through holding company system was found to have made a statistically significant and positive improvement in profit efficiency of banks. That is, regardless of variables - whether it was “(interest income - interest expense)/total asset” or “(gross profit – operating cost)/total asset” – as an indicator of profit efficiency, and with/without controlling the net period effect, mergers or integration through holding company system proved to have affected profit efficiency to some statistically significant and positive degree. This increase in profit efficiency is thought to have been made by banks’ enhanced profit-generating capability through mergers, but also influenced in large part by the post-merger banks’ increased market power and reduced competition in the concerned market. Plus, the increase in market concentration was reckoned to have significantly positive effect on profit efficiency of other banks which were not part of the mergers. In other words, the effect that market concentration had on profit efficiency seemed to expand in a statistically significant and gradual manner over a certain level (about the level of concentration of the banking industry in Korea since 2000 or 2001). This suggests that mergers between banks have improved not just profit efficiency of banks involved in the mergers but also since around 2000, they have enhanced profit efficiency of other banks not participating in the mergers due to the increased market concentration via mergers.

5.2.2 System Stabilization

It is hard to tell whether bank consolidation and the ensuing heightened market concentration will be able to enhance stability of the financial system over the long term. True, mega banks’ market power and their economies of scale and scope might help reduce the possibility of bankruptcy and furthermore raise stability of the financial system over the long term. However, in case individual mega banks fail to raise management efficiency and especially to achieve portfolio diversification which might reduce potential risk, it is hard to expect bank consolidation leading to stabilization of the financial system.

With respect to this, Kim (2003)\(^5\) conducted an empirical analysis of bank consolidation on financial system stabilization in Korea. According to the analysis, banks’ financial soundness indicators for asset quality were found to have little to do with scale variables associated with consolidation like credit increase rate or market power of individual banks. Next, an empirical analysis of banks’ bankruptcy risk evaluated by the stock market showed that market sees that Korea’s banks are relatively more susceptible to failure due to their risk-seeking asset management based on their strengthened market power through consolidation.

6. Conclusion

Korea’s financial restructuring drive launched after the Asian financial crisis, in tandem with clean-up of failing banks, liquidation of non-performing loans, and corporate restructuring, is reckoned to have achieved its given missions- overcoming of the crisis and revitalization of the economy.

\(^5\) Hyeonwook Kim(2003), Bank Consolidation and Financial Risk of the Korean Banking Industry, Korea Development Institute
Currently, as it is, the market structure of financial industry does not seem to pose a concern. Yet, just in case, restructuring efforts that would occur in the future aiming at overcoming a crisis need to be guided over the long term in a direction that may not raise concentration in the banking industry to a seriously high level. That’s because bank consolidation as a result of financial restructuring might cause a structural problem of an increase in market concentration. Particularly, as mentioned above, where mergers between banks raise not cost efficiency but profit efficiency alone through an increased market power and reduced competition, they could lead to undermining consumer interests over the long term.
KOREA

Challenges for Competition Policy in Periods of Retrenchment

1. Introduction

To cope with the Asian financial crisis in 1997, Korea carried out all-out efforts to rescue the economy ranging from granting financial aid to cash-strapped companies to promoting corporate restructuring of failing firms.

This paper aims to outline Korea’s experience and lessons it learned over the course of its overcoming the financial crisis and then touch upon their implications for other governments regarding obstacles facing them in antitrust enforcement under the current global economic downturn. First, we will take a look at corporate restructuring efforts pursued in Korea in the wake of the crisis in 1997.

2. Corporate Restructuring in Korea

2.1 Overview

Corporate restructuring carried out in Korea as a response to the crisis was initiated not by the government but by financial institutions as the government’s role was limited to ensuring that financial institutions would proceed with restructuring efforts effectively and smoothly through improvement of their financial soundness. Moreover, the objectives of such restructuring efforts were not just to overcome the crisis. Along with the short-term goal, they also aimed at overhauling the entire system from a long term perspective and thus settle an advanced market economy structure in Korea.

2.2 Substance of corporate restructuring

2.2.1 Liquidation of failing firms and improvement of financial structure

Liquidation of non-performing firms and improvement of financial structure were conducted mainly by banks, the largest creditor group, on the corporate sector in order by size, beginning with top 5 business groups, to the middling business groups from ranking 6 to 64, and to small- and medium- sized companies. According to the differentiated corporate restructuring strategy, the top 5 business groups, based on their large loss absorption capacity, were in principle guided to take care of loss on their own, while in the middling group, workout programs were agreed between the creditor banks and individual companies. In the case of small- and medium-sized companies, individual financial institutions were advised to actively aid them.

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2 Hyundai, Samsung, LG, SK, Daewoo
For starters, the gist of the restructuring for the top 5 business groups is business swaps among them and enforcement of the agreement with financial institutions on financial structure improvement. The business swap referring to efforts to pursue restructuring of overlapping investment through business spin off and consolidation will be elaborated later.

Meanwhile, improving financial structure of the top 5 business groups was another important pillar of the restructuring as domestic firms’ high debt-to-equity ratio was a direct cause to the crisis. The five business groups signed an agreement with creditor financial institutions in December 1998 on improving their financial structure, and accordingly, they went about making self-help efforts to improve their financial strength, including spin-offs as well as addressing cross-guarantee issue, increasing paid-in capital and promoting foreign investment. As a result, by the first half of 1999, their debt-to-equity ratio recorded 302.2%, a notable decrease from 470.2% of late 1997 and the top 4 business groups except for Daewoo managed to decrease the ratio below the agreed level of 200% to 146.3% by late 1999.

For the middling group (top 6~64), the restructuring efforts centered around the workout programs. In 1998, as part of efforts to coordinate different interests of multiple financial institutions participating in the programs, the Corporate Restructuring Agreement was concluded between the involved financial institutions and the concerned companies and the workout programs were carried out accordingly. Led by the prime creditor bank, creditor banks, through the internal committee in charge of determining a firm’s financial strength and viability, set out criteria for sorting out failing firms and thereby decided on which firm should enter into workout programs. Companies ruled as the subject for workout were aided with conversion of investment, debt settlement and operating cash infusion in exchange for making self-help efforts including spin-offs, foreign investment promotion and liquidation of affiliates.

From June 1998 when the workout programs were launched to late June 2002, 121 companies went through workout, and as a result, most of them returned to normal except for 8 companies that entered into insolvency proceedings. As for small-and medium-sized companies, each financial institution classified them into the group for preferred aids, the group for conditional aids and the group that does not fall under either case, and accordingly, the creditor bank would deliver focused aids to the group for conditional aids.

2.2.2 Establishment of competitive market structure

Along with efforts to facilitate exits of the already failed firms, Korea spurred its market structure reform in order to prevent mass bankruptcies from being repeated and from a mid and long term perspective, to establish a competitive market structure. The core tasks for a successful market structure reform boiled down to the following three; 1) addressing the moral hazard problem 2) improving corporate governance 3) strengthening competition through removal of barriers to market entry and withdrawal.

First, what was a key to addressing the moral hazard problem was an intensive restructuring which held accountable not just companies and financial institutions but also irresponsible individual investors. A case in point was the Daewoo Group bankruptcy in 1999 and the subsequent liquidation process, which is reckoned to be a landmark in addressing the moral hazard problem by putting an end to the “too big to fail” myth.

Unlike the court-led business reorganization procedures like corporate liquidation or composition, workout programs refer to a series of processes where with their own initiative, creditor financial institutions provisionally hold back recouping loans from individual companies facing capital erosion or troubled in reimbursing short and long term debts due to lack of liquidity, and make a decision on the viability of the concerned businesses and whether or not to give financial aid to them.
Efforts to enhance corporate governance are closely related to raising corporate transparency and strengthening accountability of CEO and controlling shareholders. Also, the outside director system was introduced to keep CEO’s arbitrary decision-making in check while minority shareholders were empowered through easing of qualifications for filing a derivative suit or claiming for accounting record inspection.

Moreover, in order to promote corporate structure rearrangement and strengthen monitoring over corporate management, M&As had to be invigorated. In fact, M&As were essential to expediting the liquidation of non-performing companies produced as the result of corporate restructuring. Plus, given that M&As could become an effective external threat to incompetent corporate management for their survival, they were thought to be effective in inducing them to make constant efforts for higher efficiency.

To this end, the Korean government pursued various institutional reform initiatives to make easier to do M&As. They include abolishment of “compulsory acquisition,” under which those wishing to acquire 25% or more of the outstanding shares of publicly held companies were required to purchase at least 50% of the shares through take over bids. In addition, establishment of holding companies was partially allowed to expedite restructuring through sell-off of non-core businesses.

Meanwhile, enforcement of the Monopoly Regulation and Fair Trade Act was strengthened to curtail undue internal assistance between affiliates of large business groups, and so between 1998 and 2000 after the economic crisis, a total of 273 companies were imposed corrective measures and 296.7 billion won in surcharge for their undue subsidization.

In tandem with efforts to fight moral hazard and improve corporate governance, elimination of barriers to market entry and withdrawal also greatly contributed to advancing market structure reform. First, a massive deregulation drive regarding strict foreign direct investment regulations was carried out, nurturing vigorous competition in the domestic market.

In fact, across all sectors except for some like broadcasting and defense, regulatory reform was conducted in a direction to promote foreign investment. For example, soon after the economic crisis hit, the item-based foreign investment cap was eased from the previous 20% to 55%, and per capita investment cap was also raised from 5% to 50%. By May 1998, except for investment by public corporations, all investment caps had been completely eliminated. At the same time, the Foreign Investment Promotion Act was legislated to attract foreign investment substantially through ways like provision of one-stop investment service for foreign investors.

Between 1997 and 2000, the total number of foreign companies’ takeover of domestic ones was 113. Koh (2007) reckoned in his paper that quick and focused infusion of foreign investment to failing companies in the wake of the crisis acted as a trigger of swift and efficient restructuring, greatly contributing to getting the economic system quickly back on track.

2.3 Achievement of corporate restructuring

The post-crisis corporate restructuring played a pivotal role in improving corporate financial condition and enhancing profitability through reduction in debt guarantee and debt-to-equity ratio. In addition, there were notable feats when it comes to system overhauling. Thanks to proactive market opening efforts,

\[4 \text{ In 1996 right before the financial crisis, the item-based investment cap for foreign investors was 20% and per capita investment cap was 5%.} \]

\[5 \text{ Ph.D. of the Korea Development Institute, “Ten years after the financial crisis: Assessment and challenges,” 2007, KDI} \]
Korea saw liberalization in sectors like FDI, foreign exchange transaction and capital market gain a great momentum, and its efforts to enhance corporate transparency and corporate governance also bore fruit, all of which helped Korea firmly settle an advanced market economic system.

3. Competition Policy Issues in Times of Economic Downturn

3.1 State aid

In Korea, over the course of the corporate restructuring to cope with the 1997 financial crisis, the government did not intervene and grant any direct aid to ailing firms. Rather, the initiative was mainly taken by creditor financial institutions, which provided cash aid to non-performing companies. However, as banks and other creditors were left with huge bad loans during the process, the government injected them with public funds in an attempt to ensure stability of the financial system. The public funds were used to purchase bad loans from financial institutions through the Korea Asset Management Corporation and to restructure financial institutions with deposit payment and investment through the Korea Deposit Insurance Corporation.

Likewise, corporate restructuring in Korea was mainly carried out not through state aid but through the private sector’s voluntary decision, and this private sector-initiated restructuring was preferred over state aid as state aid to certain industries or firms was feared to greatly undermine market competition principles. That is, state aid is considered more likely to give certain firms a competitive edge based on their low financial cost in competing with others, which leads to compromising fair competition and distorting allocation of resources by delaying the exit of marginal firms in a certain industry. Moreover, state aid to certain industries or firms might constitute a violation under WTO Agreement on Subsidies and thus stand to trigger trade disputes.

Therefore, given the possibility of market competition distortion by state aid, government assistance like state aid needs to be run in a manner to minimize its negative effects on solid companies and distortion on market competition.

In fact, since September 2008 when the global financial crisis struck, governments the world over seem to be rushing to give direct cash aid to its auto and chip industries. Yet, this approach should be taken with extra caution as such direct financial support might lead to undermining fair competition between companies. The KFTC deems that to minimize distortion of market competition, rather than for the government to grant direct aid, it is more desirable for creditor banks and other financial institutions to voluntarily and thoroughly examine and assess viability of firms and determine whether to give them financial help.

3.2 Merger review

3.2.1 Overview

After the 1997 financial crisis, as several M&A related laws and regulations concerning restructuring of failing firms and foreign investment promotion were improved, the number of M&A cases handled by the KFTC has since increased by a large margin. During this process, business swaps among large corporations as part of restructuring efforts and takeover of failing companies surfaced as major issues concerning merger review.

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6 The number of merger cases handled by the KFTC: 418 in 1997, 486 in 1998, 557 in 1999, 703 in 2000
3.2.2 Large business swaps

Large business swaps among the top 5 business groups were presented as an attractive tool with which the government could take the initiative in corporate restructuring to respond to the financial crisis at a time when M&As had yet to become active in the country. Business swaps and consolidation among large corporations were designed to seek readjustment in overlapping investment in 8 sectors; oil refining, petrochemical, semiconductor, railway vehicle, airplane, generation facilities and vessel engine.

As a result, railway vehicle, airplane and vessel engine sectors saw a consolidated corporation while generation facilities, semiconductor and oil refining sectors saw business transfer. In petrochemical sector, after negotiations to attract foreign investment collapsed, the concerned companies separately went about restructuring. Meanwhile, in the automobile sector, a business swap deal was pursued between Samsung and Daewoo only to early failure and eventually automobile units of Samsung and Daewoo respectively underwent court receivership before being sold to Renault Motors and GM respectively.

Whereas there was a voice calling for the KFTC to ease the merger review-related regulations to facilitate the business swaps, the KFTC recognized the need to minimize the harmful effects from restrained competition through the business swaps and so conducted strict review on every single business swap concerned.

KFTC’s merger review found that most of the business swaps were clear of anti-competitive effects. However, when it comes to railway vehicle and generation facilities sectors, concerns were raised over the potential anti-competitive effects by supply monopoly in the relevant market created by the concerned business swap. In response, the KFTC banned the swaps, but instead, allowed the proposed merger as an exception as it was deemed as a merger with a non-viable firm.

Business swaps among large companies conducted in Korea in the wake of the 1997 financial crisis have been consistently under criticism, for they were initiated by the government not by the private sector. In this light, the government’s intervention in the market even during an economic downturn, albeit inevitable to some degree, should be approached with extra care so as not to undermine market mechanism.

3.2.3 Merger review

During the restructuring process in the wake of the 1997 financial crisis, M&As with failing firms surfaced as a controversial issue, raising a question of whether or not such M&As should be regarded as an exception to be authorized.

During 1996 and 2000, out of 17 mergers that required KFTC’s review regarding their potential anti-competitive effects pursuant to the MRFTA, the KFTC granted approval to 6 cases, conditional approval to 9 cases to counter the potential anti-competitive effects that the mergers might have (conditions include transfer of part of operating asset to a third party and restriction of market share and price raise), and disapproval to the rest of 2 cases.

For its part, the KFTC found it necessary to allow takeovers of failing firms so as to ensure a smooth restructuring process through M&As while strictly banning M&As that might create anti-competitive effects.
Accordingly, the KFTC amended the MRFTA on February 5, 1999 to allow M&As with non-viable firms as an exception. In addition, Article 12-4 of the Enforcement Decree of the MRFTA stipulates the requirements for mergers with failing firms to be allowed as exception as follows.

(i) where the firm’s production facilities are difficult to utilize in the concerned market but for the concerned merger, (ii) where there are no other options than the concerned merger to have less anti-competitive effects

The Guideline for Merger Review defined a non-viable firm as a firm whose financial structure is extremely bad to face insolvency or likely to in the near future, and in determining whether a firm is non-viable or not, the Guideline required several factors to be considered including comparison between total capital and paid in capital, between operating profit and interest paid, and whether the concerned firm is under court receivership or workout program by financial institutions.

Pursuant to the Guideline, the KFTC has allowed the following mergers with failing firms as exceptions.

For starters, the KFTC authorized Hyundai Motor’s acquisition in shares of Kia Motors in 1999 as it recognized Kia Motors as a non-viable firm for the following reasons. First, the firm entered into court receivership on October 24, 1997 by the request of its creditor group, and second, as of June 30, 1998, its gross capital in the balance sheet reached 5.1652 trillion won and between 1994 and 1997, its accumulated current account deficit amounted to 4.5947 trillion won. Plus, the KFTC saw that but for the concerned merger, production facilities of Kia would be liquidated in the relevant market, and factored in the fact that Kia Motors was unable to recover on its own under court receivership and so pursued merger with Hyundai Motor after two times of unsuccessful international competitive bidding in the manner of preemptive rights to new shares by third parties. All things considered, the KFTC concluded that there were no other viable options with less anti-competitive effects than the merger option, thereby authorizing the concerned merger as an exception.

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7 In the pre-amendment periods (before 1999), the requirements for a merger to be recognized as an exception to be authorized came in two – industrial rationalization or strengthening of national competitiveness –, and a merger with a non-viable firm fell under the former category.

8 Whether or not a firm is non-viable is to be determined based on the following criteria. (Guideline for Merger Review, April 15, 1999)

- Whether the firm's total shareholder's equity in its balance sheet is less than the paid-in capital for a considerable period of time
- Whether the firm's operating income is less than the interest expense for a considerable time, and the firm records ordinary loss during that period of time
- Whether the firm has filed for bankruptcy as prescribed in Article 122 (1) or 123 (1) of the Bankruptcy Act
- Whether the firm has filed for the commencement of composition as prescribed in Article 13 of the Composition Act
- Whether the firm has filed for the commencement of liquidation procedure as prescribed in Article 30 of the Corporation Liquidation Act
- Whether the firm is under the management of its creditor financial institution because the firm concerned entered into a contract to delegate management to the financial institution for the disposal of bad loans
However, Park and Lee (2007)\textsuperscript{9} pointed out that the merger approval contributed to near monopolization of the domestic automobile market and there were quite a few arguments that alternative mergers with less anti-competitive effects rather than the approved merger would have been possible.

Regarding the LG Chemical’s takeover of Hyundai Petrochemical’s PVC operation in 2000, the KFTC recognized that Hyundai Petrochemical had recorded current account deficit for consecutive two years - in 1998 and 1999 - and was on its course to recording deficit again in 2000, constituting a non-viable firm status. The KFTC found that the company’s PVC operation also had recorded current account deficit between 1998 and the first half of 2000, constituting a failing operation. Plus, considering that but for the sell-off of the PVC operation, Hyundai Petrochemical would be forced to file bankruptcy due to lack of liquidity and face exit from the market, and there was no options other than the merger for Hyundai to be sold to a third party, the KFTC authorized the concerned merger as an exceptional case.

3.3 Cartel regulation

As seen during the Great Depression in the US, in times of retrenchment, the case for exempting cartel activities from competition law application as a measure to overcome a crisis might be made. This is based on the ground that instead of mergers that might cement monopolization in times of a transient downturn, allowing cartel activities temporarily is a better option, for it is possible to reverse the temporary decision when the economy recovers back, and it is considered relatively less anti-competitive.

In fact, even before the financial crisis, the KFTC had already a regulation in place to exempt cartels from antitrust application \textsuperscript{10} when the cartels were deemed to be relevant to overcoming a crisis and to rationalizing industries, and there were actual exemption cases\textsuperscript{11}.

However, the argument that cartels aiming at overcoming a crisis and rationalizing industries should be exempted from antitrust application has never gained traction even during the 1997 crisis, and the KFTC also did not exempt any cartels during the period.

On the contrary, the KFTC chose to strengthen antitrust enforcement against cartels during the period. It sternly cracked down on cartel activities in the sectors where such collaboration activities had been deeply embedded, including banks’ service fees, public sector bid-rigging and cartels involving air conditioning, cement and beer.

These efforts paid off. The number of surcharge imposition cases against cartels marked 19 in 1998, 15 in 1999, and 12 in 2000, a notable increase as opposed to the pre-crisis period. The amount of surcharge imposed also gradually increased, with 1.092 billion won in 1997, 32.058 billion won in 1998, 38.835 billion won in 1999 and 196.748 billion won in 2000.

In addition, the KFTC enacted the “Omnibus Cartel Repeal Act” in February 1999, removing 20 cartels that were sanctioned under other laws designed to protect and nurture certain industries, including

\textsuperscript{9} Professor of Dong-A University, Hanyang University respectively, “Case studies on the effects of merger remedies”

\textsuperscript{10} Article 19 (2) of the MRFTA sets out objectives with which cartels may be sanctioned, including industrial rationalization, research and technology development, overcoming of a crisis, rearrangement of industrial structure, rationalization of transaction terms, and enhancement of competitiveness of small-and medium-sized enterprises.

\textsuperscript{11} Since 1981 and until the financial crisis hit, the KFTC had authorized 7 cartels.
collective price setting and sales quota adjustment, and thereby promoting competition in the overall economy and consumer welfare\textsuperscript{12}.

4. Conclusion

Out of Korea’s experience during the financial crisis and the lessons it learned from it, it should be noted that corporate restructuring efforts to cope with the current economic crisis could be carried out more effectively when they are pursued mainly through financial institutions’ initiative rather than direct government intervention.

Equally noteworthy is that the corporate restructuring should be instrumental to establishing a competitive market structure from a long term perspective. In the case of Korea, the lack of competition was widely pointed out as a main culprit for the 1997 financial crisis, and this recognition led to building a social consensus on the necessity to promote competition, which in turn enabled Korea to pursue a long-term based competition promotion policy.

At the same time, Korea’s experience shows that in times of an economic crisis, most government agencies tend to overlook the potential negative effects on competition that the policy tools they use to overcome the crisis. This tendency calls for more vigorous competition advocacy efforts on the part of the competition authority.

In addition, in periods of retrenchment, countries should make extra efforts to make sure that mergers as the result of restructuring process do not restrain competition in the relevant market so as to prevent the harmful effects created by restrained competition from worsening the already bad economy. Plus, in times of a crisis, as businesses are more likely to resort to unfair trade practices like cartels or abuse of dominant positions, there should be more thorough monitoring and enforcement against such anti-competitive conduct.

\textsuperscript{12} Main examples include fee setting of certified professions, restriction in supply areas for liquor sales, and premium setting of insurance business.
MEXICO

Financial Sector Conditions and Competition Policy

1. Introduction

This document presents a brief description of the Mexican Banking sector and its recent performance. It provides an overview on the efforts that different areas of the Mexican government have undertaken to increase competition in a highly concentrated market with low penetration in the economy.

In recent years, the government has promoted and implemented reforms based on the vision that competition principles are not in conflict with objectives of stability and viability of the financial system. These reforms are increasing competition and improving market performance without compromising its resilience: penetration of banking services is rapidly increasing and concentration and price levels are declining.

The document is structured as follows. After this introduction, section two describes the recent evolution of the banking sector. Section three presents the regulatory framework and the key reforms undertaken during recent years. Section four analyzes the structure of the market and section five the behavior of margins and prices. Section six highlights the main remaining obstacles to competition, and section seven presents the final considerations.

2. Recent Evolution of the Sector

Penetration of retail banking services (saving, borrowing and payment instruments to customers and small and medium enterprises) has increased rapidly in recent years. However, it still lags behind international benchmarks.

2.1 Banking Deposits

Between 2000 and 2007 the number of deposit accounts grew at an average annual rate of 11.2%, and the associated funds increased from 17.5% to 19.0% as a percentage of GDP. The number of banking branches rose as well by 35.7% during this period. On the other hand, mutual funds, which represent an alternative to bank deposits, also increased their participation in GDP from 3.7% to 7.3% in the same period.

2.2 Credit to Consumption.

During 2000-2007, credit to consumption provided by banks registered an average annual growth rate of 36.2%. This credit rose from 4.1% to 27.4% and from 0.7% to 4.8% as a percentage of total banking credit portfolio and GDP, respectively.
2.3 Housing Credit.

Between 2000 and 2007, the credit for housing provided by banks increased at an average growth rate of 5.6%, and it increased its share of the total banking credit portfolio from 12.7% to 16.1%. In 2007, credit for housing accounted for 8.4% of GDP. The state’s financial intermediary (INFONAVIT) holds 58% of this portfolio, banks, 32.5%, and non-bank intermediaries (Sofoles), 8.7%.

2.4 Payment Cards

During 2002-2007 the number of credit and debit cards registered an average annual growth rate of 25.3% and 9.4%, respectively. The per capita number of credit and debit cards went from 0.06 and 0.32 to 0.23 and 0.48, respectively. Similarly, the number of payment card transactions rose by 47%, while the value of these transactions at point of sale terminals (POS) as percentage of GDP went from 0.34% to 1.07%.

2.5 Payment card infrastructure.

Although the number of establishments that accept payment cards is still relatively low, it has clearly improved in recent years. During 2002-2007 the number of POS increased by 215% and the number of automated teller machines (ATM) by 72%.
2.6 Electronic banking.

During 2002-2007 the number of internet fund transfers increased at an annual average growth rate of 61%, while the associated funds went from 9.1% to 53.9% as percentage of GDP. Similarly, the number of electronic banking transfers increased by 200%, and the funds transferred rose from 37.2% to 120% as percentage of GDP.

2.6.1 Relative penetration of retail banking services

Despite this rapid growth, retail banking services in Mexico still report low levels of penetration in the economy. For example, in 2007, bank deposits in Mexico represented 21% of GDP, which is slightly higher than this indicator in Colombia (20%) and Argentina (20%), but much lower than in Chile (49%), Brazil (56%), France (69%), Australia (85%), Canada (123%) and United States (142%).

In terms of credit to the private sector there is a major lag even when compared to countries in the region with similar development. For instance, in Mexico credit to the private sector as a percentage of GDP was 25% while in Chile, Colombia and Costa Rica this figure amounted to 89%, 46% and 40%, respectively.

![Domestic Credit to Private Sector 2007 (% GDP)](image)

Source: WDI, World Bank.

The lag is also evident in terms of payment cards infrastructure. In 2007, Mexico had 38.4 ATMs per 100,000 inhabitants, which is comparable with this indicator in Chile (37.3), but substantially lower than that in Brazil (78.6); France (75.6); UK (99.8) Spain (132.6); United States (131.8) and Canada (174.6). In terms of POS per 100,000 inhabitants the gap is even greater: Mexico had 405, while Chile had 783, Brazil 716; France, 1,807, UK, 1,739, Spain, 2,929, United States, 1,729, and Canada, 1,814.

3. Regulatory Framework

The credit and banking infrastructure expansion is partly due to a series of pro-competitive reforms undertaken in recent years. Underlying these reforms is a common perception that the promotion of competition and a strong prudential regulation are compatible. In this regard, the Federal Competition Commission (CFC) has shared diagnosis with financial regulators.
Financial regulators have been important promoters of competition in banking services. They have introduced measures to increase transparency of charges to users, obligatory standard basic accounts and a more pro-competitive approach in the regulation of the payment systems.

The Mexican banking system is far from being competitive; however to a great extent the lack of competitiveness is associated to historic inertia rather than to competition restrictions derived from the current regulatory framework.

3.1 Regulatory Bodies

Banking services are provided mainly by three types of financial entities: “Multiple Purpose Banks” (banks), which are the only entities allowed to receive deposits from the public, Financial Societies of Limited Purpose (Sofoles), and the Financial Societies of Multiple Purpose, (Sofomes). Sofoles and Sofomes are legal figures created in 1990 and 2006 respectively with the objective of reducing legal requirements to participate in financial intermediation activities. A Sofol is a financial entity specialized in a single credit activity, while a Sofome is an entity whose main activity is to provide credit or lease, although not necessarily in a specialized fashion. Both types of entity can fund its activities through capital, issuing debt titles or by contracting debt with other financial institutions. Due to the flexibility of the Sofom, many Sofoles are changing to this new legal form.

The legal framework that rules banking activities comprises specific provisions regulating issues such as requirements to start up an institution, prudential regulation, consumer protection and operation of payment systems.

Financial regulations are enforced by the Central Bank (Banxico), the Finance Ministry, the National Banking and Securities Commission (CNBV) and the National Commission for the Protection of Financial Users (CONDUSEF).

3.2 Entry requirements

Mexican law imposes specific requirements to obtain a license to operate, which depend on the type of financial entity. These requirements basically involve describing the intended operations and decision bodies, demonstrating experience in the financial sector and, exhibiting the minimum capital required. The Finance Ministry is the regulator in charge of granting licenses to operate a financial entity.

3.2.1 Minimum Capital requirements

This requirement varies depending on whether the financial entity is allowed to receive deposits from the public. In the case of banks, minimum capital requirements depend on the scope of activities: Banks providing all the regulated activities have a requirement of 90 million UDIS\(^1\), (about US$29 million); and specialized banks providing only some of the regulated activities require no less than 36 million UDIS (about US$11.6 million). Meanwhile, Sofoles have a minimum capital requirement of 10.5 million UDIS (about US$3.4 million) and Sofomes do not require a minimum capital.

3.3 Prudential Regulation

Prudential regulation in Mexico applies only to banks, as well as to Sofoles and Sofomes belonging to a regulated financial group. Since the 1\(^{st}\) of January 2008, banking institutions are subject to the guidelines

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\(^{1}\) UDI –Investment Unit.- Accounting unit whose value varies proportionally with inflation.
of the Basel Committee on Banking Supervision including its three pillars: capital requirements according to the entity risk, effective supervision process and prompt disclosure of information to the market.

The minimum level of capitalization is defined according to the types of risk (credit risk, liquidity and operational), and kind of asset. Risk may be calculated through a standard model of the National Banking and Securities Commission (CNBV), or through a previously approved internal model of the financial entity.

Banks are obligated to disclose their financial statements to facilitate market discipline, providing incentives for banks to stay in a healthy position in order to avoid scenarios where savers could transfer their funds to other institutions. Sofoles not belonging to a regulated financial group are only obliged to provide accounting information to regulators.

The National Banking and Securities Commission (CNBV) is the regulator responsible for enforcing prudential regulation.

3.4 **Information and consumer protection**

All the entities in the banking system are obliged to publish and to provide consumers the Annual Total Cost (CAT) of the loan, which is a measure of the cost of the credit in percentage terms, including fees and additional charges other than the interest rate of the financial product. This indicator is equivalent to the Annual Percentage rate in the UK and to the Equivalent Annual Rate in Spain, which is calculated as the internal rate of return in compound terms.

The Law for the Protection and Defense of the Financial Services Users demands the CAT to be visible in any credit contract amounting to less than 900,000 UDIS (around 300 thousand USD), and I every housing loan contract.

As its name indicates, the National Commission for the Protection of Financial Users (CONDUSEF) is responsible for protecting the rights of customers of financial entities.

3.5 **Payment Systems**

The Law of Payment Systems entitles Banxico, the central bank, to regulate payment systems. This law awards it the authority to approve internal codes of any payment system and to oversee their operation. Additionally the Law of Credit Entities empowers Banxico to regulate interest rates, fees and other characteristics of the payment systems. Finally, the Law for Transparency and Order of Financial Services establishes that Banxico can regulate interchange fees if there are no reasonable conditions of competition, based on the opinion of the Federal Competition Commission. In this case Banxico determines the basis for regulation.

3.6 **Recent reforms**

While the endeavor to increase competition in the banking sector has been a decade long effort, many reforms were only recently developed.

3.6.1 **Reduction in the minimum capital requirement**

One of the most important changes undertaken recently is the reduction of the minimum capital required to start up a bank, as well as the creation of the legal figure of specialized or “niche” bank. This is one of the dimensions that the CFC had signaled as an obstacle to the competitiveness of the banking sector.
In February 2008 a reform in the Law of Credit Entities abolished the rule that obliged every bank to have at least .12% of the net assets of the Mexican banking system, an amount equivalent to around 37 million USD in 2007. This amount used to increase every year along with the growth of the assets of Mexican financial system.

The new minimum capital rules broke the link between the size of the banking system and the capital needed to start up a bank, and reduced it by 13.6%. Additionally, the concept of specialized bank was introduced, requiring just 34.5% of the capital required in 2007 (around 11.6 million USD)².

3.6.2 Prudential rules

Starting January 2008 the Basel II guidelines are binding for the banks in Mexico. This implies that capitalization requirements will be adjusted according to the risk and institutional profile of each bank.

3.6.3 Transparency

The legal framework obliges financial entities to provide information to their clients in a clear fashion. The Law for transparency and order of financial services obliges banks to provide clear information on all the charges related to their products, and to provide this information through their internet sites and their branches.

3.6.4 Bank Co-responsible

In December 2008 the Unified Banking Regulation of the CNBV was modified in order to allow the operations of “bank co-responsible”. A bank co-responsible is a firm that does not belong to a financial group, but that is capable, through a contract, of acting on behalf of a bank as a branch in order to receive payments, pay withdraws and perform other kind of transactions. The objective of this reform is to reduce costs of establishing branches, in particular for entrants, and eventually to help the banking institutions to reach a large part of the population that currently does not use these financial services.

3.6.5 Payments via Mobile Phone

The largest banks in Mexico participate in the Trust to Extend the Benefits of Access to Payment Means to Society, (FIMPE), a nonprofit organization that, together with the CNBV has begun the operation of a payments platform based in mobile phones. This platform will link a phone number to a bank account, allowing users to transfer funds using only a PIN and an SMS message. The objective is that every mobile phone attached to a bank account becomes equivalent to a payment card or to a POS.

3.6.6 Basic Accounts

Since December 2007, the Law of Credit Institutions entitles the central bank to establish the characteristics of basic bank accounts and payroll accounts, which, by law, cannot have a cost for the account holder. These accounts are designed to attract low income users to the banking system.

3.6.7 Payroll transfer

Another aspect for which the CFC issued recommendations concerns the transfer of payroll accounts among banks. In contrast to other jurisdictions, in Mexico the employer decides which bank will receive

² Amounts might not correspond due to difference in exchange rates for 2007 and 2008.
the worker’s payroll funds. This scheme is inconvenient since the person who chooses the bank does not pay the fees for the account.

As a result of this recommendation, in October 2008 the Law of transparency and order of the financial services was reformed, allowing workers to ask the bank to transfer its payroll payments to their preferred bank account. This policy reduces significantly the switching costs and imposes some discipline to the banks regarding the fees charged for this kind of product.

4. Mexican Banking Structure

The Mexican banking system comprises 43 banking institutions, which control over 53% of the assets of the Mexican financial system. This percentage has declined, since other financial institutions have gained market share, mainly the Sofoles and Sofomes.

Of the forty three existing banks, twelve began their operations over the last two years. This is an indication that the efforts to reduce the regulatory burden in the sector have achieved their purpose, allowing entry of new players in the market.

One of the essential characteristics of these banks is that a high proportion of them are targeting segments of the population that have no access to banking services in general, and whose access to credit is extremely limited and costly.

The Mexican banking sector is highly concentrated. For example, the joint market share of the four largest banks (CR4) is above 60% in almost all measures. The largest well established banks have an extensive nationwide network that provides them with a significant advantage over new participants. The particularly high concentration of operational profits reflects this position of the largest banks.

**Concentration Indicators, 2008**

<table>
<thead>
<tr>
<th></th>
<th>CR2</th>
<th>CR4</th>
<th>IHH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>40.4</td>
<td>64.4</td>
<td>1,296</td>
</tr>
<tr>
<td>Total Credit</td>
<td>41.0</td>
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<tr>
<td>Deposits</td>
<td>40.6</td>
<td>64.9</td>
<td>1,401</td>
</tr>
<tr>
<td>Net Profits</td>
<td>53.5</td>
<td>78.2</td>
<td>2,088</td>
</tr>
<tr>
<td>Operational Profits</td>
<td>62.0</td>
<td>83.3</td>
<td>2,383</td>
</tr>
<tr>
<td>Branches</td>
<td>32.5</td>
<td>59.1</td>
<td>1,150</td>
</tr>
</tbody>
</table>

Source: CNBV
Most concentration measures show a clear downward in recent years. Although some show a less pronounced decrease, particularly total accounts’ concentration.

### Concentration Indicators

<table>
<thead>
<tr>
<th>Concept</th>
<th>2003</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CR2</td>
<td>49.2</td>
<td>40.6</td>
</tr>
<tr>
<td>CR4</td>
<td>73.1</td>
<td>64.9</td>
</tr>
<tr>
<td>Branches</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CR2</td>
<td>39.4</td>
<td>32.5</td>
</tr>
<tr>
<td>CR4</td>
<td>69.8</td>
<td>59.1</td>
</tr>
<tr>
<td>Total accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CR2</td>
<td>49.5</td>
<td>43.8</td>
</tr>
<tr>
<td>CR4</td>
<td>73.9</td>
<td>71.8</td>
</tr>
</tbody>
</table>

Source: CNBV

In spite of this decline, the Mexican banking system is still highly concentrated in comparison to international benchmarks.

### Banking concentration among several countries 2007, (CR5)

Source: WDI, World Bank.
4.1 Credit

The four largest established banks still have a large share of the credit market. However, recent legal reforms have allowed non-bank financial intermediaries (Sofoles and Sofomes) to participate in this activity, which has reduced the market share of the established players. This is the case of the credit market for the purchase of durable goods and housing.

**Market concentration evolution**

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit Cards</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CR2</td>
<td>83.3</td>
<td>72.8</td>
<td>70.7</td>
<td>68.4</td>
<td>68.2</td>
<td>62.7</td>
</tr>
<tr>
<td>CR4</td>
<td>97.7</td>
<td>90.6</td>
<td>89.7</td>
<td>87.9</td>
<td>88.0</td>
<td>87.3</td>
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<tr>
<td><strong>ABCD</strong></td>
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</tr>
<tr>
<td>CR2</td>
<td>76.8</td>
<td>67.0</td>
<td>47.3</td>
<td>41.4</td>
<td>35.3</td>
<td>29.8</td>
</tr>
<tr>
<td>CR4</td>
<td>93.1</td>
<td>85.9</td>
<td>73.2</td>
<td>66.3</td>
<td>61.2</td>
<td>52.9</td>
</tr>
<tr>
<td><strong>Mortgage</strong></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CR2</td>
<td>33.6</td>
<td>27.3</td>
<td>34.1</td>
<td>29.5</td>
<td>35.1</td>
<td>40.4</td>
</tr>
<tr>
<td>CR4</td>
<td>55.5</td>
<td>49.3</td>
<td>54.1</td>
<td>48.8</td>
<td>52.0</td>
<td>55.3</td>
</tr>
</tbody>
</table>

1/ Include Banks and Sofoles  Source: CNBV

The credit market for durable goods (ABC) is among those with the largest increase in levels of competition; the market participation of the two most important players (CR2) has substantially decreased, falling from 76.8% in 2001 to 29.8% in 2006.

The credit cards market concentration remains strong. This is not surprising since there is no significant entry of new financial intermediaries into this market, although the two largest banks, BBVA Bancomer and Banamex-Citigroup, have lost almost 20% of the market for credit cards in 5 years.

Finally, data on housing credit reveal that market concentration has remained relatively constant during a period 2001-2006, in spite of an important expansion of this type of credit.

4.2 Payment Cards

Unlike other countries, in Mexico the payment cards market operates on a single open platform, whose interchange fees are set by the Mexican Association of Banks (ABM). Although the international players, Visa and MasterCard, operate in Mexico, they are only involved in the market through the...
provision of trademarks and international links. In addition to this open platform, there is another player in the market, American Express, which operates its own close platform, but has a very small market share\(^3\).

Although the system works as a single platform, banks rely on two different switches for their transactions, E-Global and Prosa. These switches authorize transactions and perform the transfers netting among banks. E-Global works only for the two largest banks, BBVA Bancomer, and Banamex Citigroup, which are its shareholders. Prosa, by contrast, provides its services to various banks, including non shareholders.

In 2007 the two largest banks (BBVA Bancomer, and Banamex Citigroup) accounted for 51% of credit cards and 48% of debit cards, while the CR4 of the two markets was 81%. In the acquisition business, these two banks had 50% of the point of sale terminals (POS) in the same year.

### Concentration Indicators

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<tbody>
<tr>
<td>Credit</td>
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<td>Debit</td>
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<td>POS</td>
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<tr>
<td>Issuer</td>
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<td></td>
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</tr>
<tr>
<td>Acquirer</td>
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<td></td>
<td></td>
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</tr>
</tbody>
</table>

| # of banks | 11 | 17 | 15 | 21 | 8 | 13 | 14 | 19 | 8 | 13 |
| CR2 | 65 | 51 | 66 | 48 | 55 | 50 | 68 | 56 | 72 | 70 |
| CR4 | 89 | 81 | 91 | 81 | 85 | 82 | 92 | 85 | 90 | 90 |
| HH | 2,570 | 1,900 | 2,536 | 1,843 | 2,113 | 1,910 | 2,914 | 2,079 | 2,846 | 2,825 |

\(a/\) Data from 4th Trimester of 2002; \(b/\) Data from 4th Trimester of 2007

*Source: Banxico.*

Between 2002 and 2007 most concentration measures have decreased, except for the transactions in the acquisition business. However, this trend has not been enough for the Mexican market to reach concentration levels comparable with international standards.

On the other hand, the acquisition business does not seem highly concentrated when compared with other countries.

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\(^3\)In terms of credit cards fees, American Express had 4.0% of the total in 2007.
However, this lower concentration in the acquisition business does not necessarily mean higher competition in deterring margins, since interchange fees are jointly fixed by all the banks through the ABM. For instance, Sampere (2008) estimates that the issuers’ margins per transaction are 65% and 81% for credit and debit cards respectively, and acquirers’ 36.9% and 27.6%. According to the author, these margins cannot be justified on large fixed costs grounds.

5. Income and margin structure.

Banks income comprises mainly the adjusted financial margin, net fees and intermediation income. In September 2008, these components represented 68.5, 27.5 and 4% of total banks’ income, respectively. During 2001-2008, the participation of intermediation decreased from 13.4 to 4%, while that of the financial margin and the net fees increased from 61.7 to 68.5% and from 25.1 to 27.5%, respectively.

The credit risk-adjusted financial margin as proportion of assets has shown a procyclical behavior during this period, with a peak at 5.4% during 2006.

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Consumption credits play a leading role in determining total banking interest income. In 2008, consumption credits represented 24.6% of banking credit portfolio, and 49% of banking interest income. This situation results from consumption credits paying much higher interest rates than other types of credits.

The differential in interest rates is explained partly by the different levels of risk associated to each kind of credit. During the period 2002-2008, a large share of the consumption credits were given to individuals without credit history.

Banks are subject to a strong competitive pressure in almost every type of credit, except for consumption credits, where credit cards remain the main component of total loans (62.5%), and where non banking entities have a negligible market share.
Credit margins, measured as the implicit interest rate minus the equilibrium inter-bank interest rate (TIIE\textsuperscript{5}), for commercial credits, housing and government have diminished, whilst the credit margin in credit cards has increased in 8.16%, from 15.71% to 23.87%.

![Financial margin by type of credit](image)

Source: CNBV

On the other hand, the passive rates margin, measured as the equilibrium inter-bank interest rate minus the average interest paid to savers and deposit account holders, has increased by 79 base points, from 2.94 to 3.73, although with an erratic behavior during the period 2003-2008. This same margin, measured as the proportion of passive rate margin divided by the equilibrium inter-bank interest rate has been relatively stable around 50%.

### Margin and cost on Deposits

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Deposit Cost(CC)</th>
<th>TIIE %</th>
<th>(CC/TIIE) %</th>
<th>Margin on Deposits (CC-TIIE)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>3.3</td>
<td>6.3</td>
<td>53.2</td>
<td>2.9</td>
</tr>
<tr>
<td>2004</td>
<td>3.9</td>
<td>7.6</td>
<td>51.3</td>
<td>3.7</td>
</tr>
<tr>
<td>2005</td>
<td>4.7</td>
<td>8.7</td>
<td>54.1</td>
<td>4.0</td>
</tr>
<tr>
<td>2006</td>
<td>3.6</td>
<td>7.3</td>
<td>49.6</td>
<td>3.7</td>
</tr>
<tr>
<td>2007</td>
<td>3.9</td>
<td>7.9</td>
<td>48.9</td>
<td>4.1</td>
</tr>
<tr>
<td>2008</td>
<td>4.2</td>
<td>7.9</td>
<td>53.0</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Source: CNBV and Banxico

\textsuperscript{5} Inter-bank equilibrium 28 days Rate (TIIE), year average. TIIE is the bank system reference rate.
5.1 Fees

During the period 2000-2007 net banks’ fees have increased at an average annual rate of 12.7% in real terms, and have increased their share in total banks’ income from 25.1% to 31.5%. Net fees as a share of operation expenses increased from 27.8% to 39.2% during the period 2000-2008.

Net fees / Operation Expenses

![Graph showing the increase in net fees and operation expenses from 2001 to 2008.]

Source: CNBV y Banco de México.

During the period 2002-2008 the fee structure changed substantially. Fees associated with credit cards rose from 29.4% to 44.6% as percentage of total fees, while those related to fund transfers decreased from 23.6% to 14.5%, and online banking and funds transfer rose from 8.8% and 1.7% to 9.8% and 4%, respectively.

Average fees for credit card use show a decreasing tendency. The fee to open an account in 2002 was about 7.5 USD; while in 2008 none of the existing products charged this kind of fee. Between 2003 and 2008 fees for dismissed claims decreased by 28.6%, while annual fees for additional cards and for card reposition declined in 32.1% and 16.9%. The only concept that presented an increase was the annual fee of the main card holder, by 3.2%.

Credit Card Fees

(Real Pesos, December 2008)

<table>
<thead>
<tr>
<th>Concept</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Fee</td>
<td>98</td>
<td>95</td>
<td>63</td>
<td>59</td>
<td>16</td>
<td>0</td>
</tr>
<tr>
<td>Main card holder</td>
<td>399</td>
<td>328</td>
<td>396</td>
<td>403</td>
<td>338</td>
<td>413</td>
</tr>
<tr>
<td>Annual Fee, additional card</td>
<td>273</td>
<td>212</td>
<td>136</td>
<td>179</td>
<td>149</td>
<td>185</td>
</tr>
<tr>
<td>Reposition</td>
<td>164</td>
<td>153</td>
<td>140</td>
<td>136</td>
<td>143</td>
<td>137</td>
</tr>
<tr>
<td>Dismissed claim</td>
<td>n.d.</td>
<td>203</td>
<td>177</td>
<td>173</td>
<td>162</td>
<td>145</td>
</tr>
</tbody>
</table>

Source: Condusef
5.2 ATM’s

Debit cards are used mainly for transactions in ATMs. For instance, in March 2008, 80.1% of the transactions were cash withdrawals at ATM’s, and only 19.1% were transaction at POS. In the case of credit cards, this situation is inversed, since 82.8% of transactions were at POS and 17.2 at ATMs.

Debit cardholders pay relatively low fees for transactions at ATM owned by the issuer bank, and in general have the right to a certain number of transactions without cost. By December 2008, for instance, banks charged in average 3.5 pesos (around .26 USD) per withdrawal and 1 peso (around .07 USD) to check an account balance.

However, if the cardholder uses an ATM of another bank, then it pays substantially higher fees, one to the issuing bank and one to the owner of the ATM. In 2008, cardholders paid 19.7 pesos (around 1.45 USD) per withdrawal at ATM owned by a bank different to the issuing bank, and 9.1 pesos (.67 USD) to check an account balance, meaning 3.1 and 6.5 times more than in the ATMs owned by the issuing bank.

In December 2008, the inter-bank exchange fee was 7.25 pesos (.53 USD) per withdrawal and 3 pesos (.22 USD) per balance check, while average issuing bank fees were 12.45 pesos (.92 USD) and 6.1 pesos (.45USD) respectively. Large banks pricing strategy may be discouraging the use of other banks’ infrastructure.

6. Remaining restrictions to competition

Recent reforms have enhanced competitive pressure in retail banking services, but there are still many opportunities to improve the regulatory framework. Below we present a non exhaustive list of remaining restrictions to competition.

Switching Costs. This kind of costs have perverse effects on competition, since they reduce savers and consumers’ mobility, allowing firms to derive economic rents. In Mexico, as in many other countries, banking services are characterized by the existence of substantial switching cost due to, among other reasons, the multiproduct character of banking services. For some services the problem is worse, for instance, users that command automatic payments confront significant costs of canceling the service and the bank account as a whole. It is necessary to design new switching arrangements to allow financial service users to change their bank at will.

Access to ATM’s infrastructure. The current pricing structure may be limiting entry and the efficient use and development of the ATM’s network. Fees for using ATMs not owned by the issuing bank are very high, inducing a pattern where only 9% of the transactions are done off-net, i.e. at ATMs owned by a different bank.

Determination of Exchange Fee. The determination of the interexchange fee associated with payment cards by the ABM may be unnecessarily increasing fees paid by merchants. High interchange fees could be the result of a competitive process to adequately balance both sides of the market. However, it is not clear this is the case in Mexico. Interchange fees seem to be a mean to increase banking margins (Sampere, 2008), since there is no competition between alternative card payments platform to discipline the fees set by the ABM.

Access to the payment card infrastructure. Additionally, there are only two switching firms, EGlobal and Prosa, both owned by well established banks, and only the latter is able to provide all the services

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6 Fees charged by an issuer bank on withdrawals in other bank’s ATMs are fixed independently and does not vary with the bank.
required to access the payment cards market to an entrant bank. Prosa has incentives to offer access to its infrastructure under conditions that provide a competitive advantage to its shareholders against new entrants.

7. Final Considerations

Recent pro-competitive reforms to the legal framework ruling the banking activity have succeeded in reducing obstacles to entry and expanding market penetration. New players (bank and non banks) have entered the market focusing on providing services to consumers segments unattended by the traditional banks. Competition is increasing and the market is expanding.

The reforms to promote competition were undertaken in parallel to an effort to strengthen prudential regulation after the macroeconomic crisis of 1995. The results illustrate that these two objectives are not in conflict and may be complementary.

The recent dynamic of the banking sector in Mexico is reducing differences with respect to international benchmarks, but the competitive gap remains high especially in comparison to other OECD countries. Market penetration is still low and banking margins and fees do not seem to reflect enough competitive pressure. Therefore, the efforts to develop a pro-competitive regulatory framework need to continue. For example, additional reforms are needed to promote competitive access to banking infrastructure and to facilitate customer mobility.
1. **Introduction**

This paper concerns the contribution of the Netherlands Competition Authority (NMa) to the Roundtable on financial sector conditions and competition policy, to be held on February 17th, 2009. In this paper we present our view on some topics of the interaction between financial sector regulation and competition policy. Given the nature of these topics, we briefly present a general vision on how to deal with issues of competition and financial sector conditions. We start with financial markets in general, followed by a brief discussion on the current financial crisis.

2. **Competition in financial markets: general principles**

In their practices, competition authorities are regularly confronted with arguments from the parties to the case along the lines of “our market is different from other markets”, thereby implying that in their case competition law should apply to a lesser extent or not at all. Cases in point are for example health care, the professions, energy, and a number of media markets. In general this concerns markets which are regulated to some degree. In specific competition cases, the NMa always takes into account the effect of regulation on the relevant market in assessing to what extent there is indeed room for possible harm to competition, caused by the particular conduct.\(^1\) The financial markets are no exception to this rule. The role of competition authorities in financial markets thus is and indeed should be the same as for other markets, i.e., making these markets work within the given boundaries.

The question then arises what these boundaries are for financial markets. As pointed out by Vickers\(^2\), the textbook problem with banks is one of confidence, based on the principle that banks borrow short and lend long. Whilst this mechanism is a highly efficient way to create money (every single borrowed euro is lent out to a number of lenders simultaneously), it is vulnerable to panic attack (i.e., ‘bank runs’). If depositors worry that others will withdraw their money from a particular bank (due to a lack of confidence), everyone else will run to withdraw their money in order to be first. In that case even a healthy, solvent bank can go bankrupt within a very short period of time. In order to support the stability of (and confidence in) the financial system, financial regulators impose solvency requirements on banks, whilst central banks provide liquidity as a lender of last resort.

Since banks lend each other money on the money markets, the failure of a (large) bank may create a systemic risk of other bank failures, even if these banks are ‘healthy’ in the sense that they are solvent and their underlying assets are sound. These banks then have a liquidity problem, caused by this negative

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\(^1\) For example, until a major reform of the Dutch healthcare system in 2003 the NMa did not supervise hospitals, since the regulation did not leave enough room for competition between hospitals.


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externality. In the popular press it is sometimes claimed that competition has caused systemic crises like the current credit crisis. However, in various academic papers it has been argued that competition is not responsible for the fragile nature of the banking sector. It has been suggested that the externalities and systemic concerns cannot even be (fully) solved by creating a state-owned monopoly bank. However, stability and competition do interact, though there is conflicting evidence as to the direction of the trade-off.

Within the framework sketched above, banks are competing on attracting borrowers and lenders, trying to maximise their profits whilst taking into account the stability requirements imposed by financial regulators. Generally speaking, competition authorities should take these requirements into account in their specific investigations. In the case of granting access to payment systems this has been explicitly addressed in article 28 of the Payment Services Directive, according to which “Member States shall ensure that the rules on access of [...] payment service providers [...] shall be objective, non-discriminatory and proportionate and that those rules do not inhibit access more than is necessary to safeguard against specific risks such as settlement risk, operational risk and business risk and to protect the financial and operational stability of the payment system”.

It should be noticed however that stability requirements are not necessarily relevant in every competition case. Indeed, in the major cases handled so far by the NMa in the area of banking, there was no interaction between competition concerns and stability. An example from the NMa practice is the case against Interpay, in which several banks were fined for joint acquisition of retail customers for payment products. Clearly, acquisition can also be done by individual banks (as is the case in many countries) without decreasing financial stability.

Another example concerns multilateral interchange fees (MIFs), which are for usually paid by the acquiring bank (i.e., the bank of retailers) to the issuing bank (i.e., the bank of the consumer) for an electronic payment transaction at a point of sale, and the level of which are agreed between different banks. The European Commission has stated in its Mastercard decision that it considers the ‘fallback’ MIF for cross-border payment transactions, which applies in the absence of bilateral agreements, to be in breach of article 81 of the EU treaty. In this example too, there are no financial stability arguments for approving this conduct, i.e., there is no interaction between competition and stability.

A final example is the implementation of the Single Euro Payment Area (SEPA) in The Netherlands. The NMa has published a vision document, in which it identifies a number of risks for competition-restricting behaviour or agreements related to this implementation. For example, banks are not allowed to

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4 See for example OECD (2007), working party no. 2 on competition and regulation, *Review of Competition in the Dutch Retail Banking Sector*, and references cited therein.

5 Ibid.

6 The NMa has been appointed as the competent authority for this article.

7 Netherlands Competition Authority (2005), case 2910, *Interpay*.


9 Netherlands Competition Authority (2008), SEPA vision document, *A single payments market, increasing competition*?
agree collectively to abandon the existing Dutch payment scheme, PIN. This and the previous examples illustrate that there are many cases in which financial sector regulation does not interfere with competition policy.10

3. Competition policy in times of crisis

As pointed out by Vickers (among others), the current financial crisis is not solely due to confidence (i.e., liquidity) problems as described in section 2, but also (possibly primarily) to ‘problems of contagion’, i.e., solvency problems and uncertainty about the value of assets. The root problem of this crisis is the large volume of bad debts, as a result of which banks have had drastically to contract their balance sheets. Equilibrium will only be restored once prices and economic activity have sufficiently decreased to meet the lower amount of available capital and the uncertainty about the value of assets has been diminished.

In our view, competition as such has not been the underlying cause of the financial crisis. The absence of sufficiently strong internal control systems combined with the perverse effects of bonuses, the influence of credit rating agencies and the limitations of supervision of financial products no longer on the balance sheets of supervised entities, together with the lack of supervision of certain financial institutions (investment banks, hedge funds, credit rating agencies) all helped to produce the crisis. In summary, banks have been able to supply loans with a high probability of default, which have been repackaged, favourably rated and subsequently resold to other banks. Negative externalities have been insufficiently addressed by regulation.

With respect to the role of rating agencies in this crisis, we point out that the current system of competing rating agencies may be feasible in principle, but it seems of crucial importance to ensure they have the right incentives, which may well require additional regulation for these agencies.11 Another option could be a single, independent rating agency.12

In the light of the discussion in section two, we would like to stress that in general competition is the engine for promoting innovation and efficiency. To give an example, in a recent study it has been shown that stronger loan market competition between banks implies significantly lower spreads between bank and market interest rates for most loan market products.13 Furthermore it was concluded in this study that “…measures to enhance competition in the European banking sector will tend to render the monetary Policy transmission mechanism more effective”. Thus rather than stating that there should be less competition between banks, the aforementioned market failures should be addressed, for example by improved financial sector regulation. As mentioned earlier, it is perfectly possible to apply competition law within the boundaries of such regulation.14 The question then is not one of more or less competition, but

10 Obviously payment systems in general play a crucial role in the financial infrastructure. As pointed out in the example on the implementation of the Payment Services Directive, stability arguments are relevant with respect to the granting of access to payment systems.
11 The fact that competing rating agencies currently are paid by the selling parties, which evidently have an interest in getting high ratings for their products, does not appear to give the right incentives.
12 In order to avoid compartmentalisation along national lines, such an institution should have international jurisdiction.
one on which type of competition is optimal. The principle of profit maximisation can bring about both the 'good' and the 'bad' aspects of capitalism. The way forward is in our opinion not to take away the incentives for profit maximisation, but to recognise and analyse the incentives for 'bad behaviour' (i.e., market failures), followed (if necessary) by proper regulation.\footnote{In this respect, it could also be useful to discern between incentives for profit maximisation on the short term vs. long term.}
NETHERLANDS

The Role of Competition Policy in Financial Sector Rescue and Restructuring

1. Introduction

This paper concerns the contribution of the Netherlands Competition Authority (NMa) to the Roundtable on the role of competition policy in financial sector rescue and restructuring measures in the light of the current financial crisis, to be held on February 17th, 2009. We start with some general remarks on the role of competition law in times of (financial) crisis, followed by brief discussions of merger control and anticompetitive conduct.

2. Competition law in times of crisis

In our contribution to the roundtable on financial sector conditions and competition policy, we have already pointed out that, rather than stating that there should be less competition between banks, the market failures that have led to the current financial crisis should be addressed by specific measures, for instance improved financial sector regulation designed to prevent the incentives that led to the crisis. Crane has given a compelling historical overview of antitrust enforcement during national (i.e., USA) crises¹ and concludes that ‘allowance of anticompetitive activity should be a last resort – as much, or more so, in times of crisis as in times of calm’. He points out that antitrust law has existing tools (e.g. the failing firm defence) that permit consideration of financial distress in evaluating competitive effects. In the words of EU Commissioner Kroes, competition rules do not stand in the way of a solution, but are part of the solution.² In this section we will elaborate on how competition law can be applied in the current crisis.

As pointed out in our contribution to the roundtable on financial sector conditions and competition policy, it is perfectly possible to take into account financial stability requirements in the assessment of concrete competition cases. In the short term it should be demonstrated firstly that the systemic problem is indeed solved by the proposed merger or anticompetitive conduct and secondly that there is no other solution which is less distorting to competition.

Furthermore, measures should be taken which ensure in the medium term the return to a ‘normal’ (i.e., competitive) market. It should be clear from the outset that any distortion to competition should be for as short a period as possible. For this reason, a structural change of the market conditions (i.e., a merger) seems a priori less desirable than more reversible measures such as a recapitalisation through state aid.

Finally, it should be noted that it is also important to take additional measures where necessary to restrict as much as possible additional competition risks during the period of market distortion. This issue is further discussed in section four.

3. **Merger control**

In some instances problems of lack of confidence in a certain bank can be solved by a takeover by another bank without confidence problems. If such a merger cannot be justified on standard grounds, a failing firm defence would be a possibility if the weaker party would exit the market without being replaced by another efficient undertaking. In order for a failing firm defence to succeed, it must be proved that the weaker company and its assets would rapidly disappear from the market if not taken over (resulting in greater damage for consumers), whilst there is no less anticompetitive solution. It should be noted that a failing firm defence is always a possibility, with or without the current financial crisis. In our view, no additional instruments are needed from a competition policy point of view.

Since in many cases less anticompetitive solutions may be available (for example an alternative merger leading to less competition problems or recapitalisation through state aid), it seems unlikely that the failing firm defence will be successfully applied in a substantial number of cases to clear anticompetitive mergers. A merger that structurally (i.e., irreversibly) harms competition should indeed only be allowed if a disallowance of the merger would be even more harmful. In this respect it should be noted that even in a failing firm situation, structural and/or behavioural remedies could be imposed to limit the harm to competition as much as possible. Again, these comments apply to the failing firm defence in general, and are not specific to the current financial crisis.

Some points can also be made on the process of merger control. Firstly, section 46 of the Dutch Competition Act allows the NMa to give merging parties a waiver from the standstill obligation imposed on them by section 41 of said act. This waiver can be conditional. This instrument enables the merging parties to resolve urgent problems, whilst the NMa can through the imposition of conditions ensure that no irreversible harm to competition is done. Subsequently, the NMa can and should be able to carry out a comprehensive merger assessment.

In conclusion it can be said that competition law offers enough possibilities, both with regard to substance and process, to address ‘emergency mergers’ in the current financial crisis.

4. **Anticompetitive conduct**

We envisage two main categories of possible anticompetitive conduct which may be triggered by the current financial crisis. The first category concerns enhanced risk of anticompetitive conduct related to

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3  For example by a bank that does not yet have a presence on the relevant geographic markets.


5  We are focussing on anticompetitive conduct falling within the framework of article 81 of the European Treaty and the corresponding section 6 of the Dutch Competition Act. Other competition risks are more related to issues of unlevel playing field created by state aid and to competition between member states on the conditions for state aid and guarantee funds. See for a more detailed account of these other competition risks: *Communication from the Commission — The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*, Official Journal of the EU, C 270/8, 25.10.2008, and *Communication from the Commission – The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition*, http://ec.europa.eu/competition/state_aid/legislation/recapitalisation_communication.pdf.
measures taken to save specific financial institution(s). Proper governance structures should be put in place in order to minimise this risk.

The second category concerns an increased risk of price fixing in general, as a response to the recession following the financial crisis. It should be noted however, that an abrupt drop in demand may also decrease the stability of possibly already existing cartels. The net effect on the prevalence of anticompetitive conduct depends on the characteristics of specific markets and is difficult to predict. An example of a market with a possibly increased risk of price fixing is the Dutch housing market. Based on newspaper articles on price fixing between real estate agents aimed at keeping house prices high (which is beneficial to real estate agents because they are usually paid for their services with a percentage of the house price), questions have been raised in Dutch parliament urging the minister of Economic Affairs to ask the NMa to investigate these allegations. This goes to show that the current financial crisis is not seen as a license to illegally fix prices. In this second category it is, in our view, very much ‘business as usual’ for competition enforcement, with special attention to those sectors which are affected most by the current crisis.
NETHERLANDS

Challenges for Competition Policy in Periods of Retrenchment

1. Introduction

This paper contains the contribution of the Netherlands Competition Authority (NMa) to Roundtable 3, on challenges for competition policy in periods of retrenchment, to be held on February 18th, 2009. We outline the NMa perspective on how competition policy can best respond in periods of retrenchment. We set out the advantages of choosing for subsidization rather than a relaxation of merger rules or a tolerance of crisis cartels as forms of Government intervention. The paper concludes with the importance of the role of the Competition Authority in periods of retrenchment.

2. Subsidisation

The position of competition agencies towards subsidies to ailing firms or sectors is based on law. Government may subsidize firms and sectors, ailing or otherwise, where Government feels it is in the common interest to do so. Where such subsidization takes place in a commercial market, Government should insure that the subsidization does not unfairly exclude other market players competing on the merits. This is not to say that no exclusion of other market players will be tolerated by Competition law. A certain element of exclusion is all but inevitable in the event of Government intervention. However, provided the intervention is proportionate to the achievement of the common good goal, Government intervention is not illegal – so for example, it is proportionate for Government to subsidize start-up industry, provided such industry does not use that subsidization to price competitors out of the market, in order to monopolize it. Indeed, Government intervention by way of (temporary), transparent subsidization is generally to be preferred over Government tolerance or encouragement of cartelization or an anti-competitive merger, as being less damaging long-term to competition and competition law enforcement – it should be ensured however that such subsidization is temporary and targeted. It should also be noted that in any case state subsidies should only be given in exceptional circumstances.

The rules on State aid applying in the Netherlands are the same as those applying in other EU member states under the Treaty. When assessing a case at national level, in which a grant or subsidy is claimed to be a breach of Dutch competition law, the NMa first applies the principles laid down in the Hofner case of the European Court of Justice to check if the subsidy is granted by an “undertaking” in the meaning of article 81 and 82 of the EC Treaty. In the Amsterdam Flowermarket case, the NMa found thus that a grant of land by the local Council could be seen as “an economic activity” to which the Competition rules should apply, rather than the Council acting “in the exercise of official authority”, and not as an undertaking.

1 Article 87 EC Treaty.
3 Decision of the Director General of the NMa, 23 July 1999, Case 101, Bloemenmarkt Amsterdam.
The Dutch Appeal Court recently discussed the issue of when subsidization could be seen as being in
breach of the national competition rules. In the Blovo/Boontje case, the NMa rejected a complaint from an
undertaking, which commercially exploited tennis courts, about a local government Council in the
Netherlands, renting tennis courts for a symbolic sum. The NMa saw the Council’s action as a form of
indirect subsidization, falling outside the reach of the competition rules which (being equivalent to articles
81 and 82 of the EC Treaty) are not applicable to situations of state aid. The Court did not agree with the
NMa on this ground. The Court referred the Wouters case and stated that the NMa should have checked
whether the activity in question was one “which, by its nature, its aim and the rules to which it is subject
does not belong to the sphere of economic activity”. In any event, the Court stated there had been no
breach of the Competition laws in this case.

Competition law is economic law. It is not a breach of competition law for Government to use its
advocacy skills to curry favour for a national champion in foreign markets. However, should Government,
in times of economic retrenchment or otherwise, interfere to protect national champions and obstruct
acquisitions by foreign investors, in a manner which is contrary to competition law, then the Competition
Authority may find itself having to take a case against the State, as happened in the CIF case. To prevent
such a situation from arising, the Competition Authority should advise Government against acting in a
disproportionate way.

3. Application of merger control

A relaxation of merger control in times of economic retrenchment could be more harmful to
competition than subsidization. While subsidies should generally be temporary, a relaxation of merger
control may allow the development of dominant firms through inefficient means, leading to permanent
structural changes in the market.

In any event, alterations to existing merger control measures is unnecessary as there are already
instruments in place to deal with mergers in situations of exceptional economic difficulty.

One such instrument is the failing firm defence, an efficiency defence stemming from US merger law,
whereby an anticompetitive merger may be permitted where it can be shown that one of the firms would
otherwise have failed financially and could not save itself through a less anticompetitive merger. The
Dutch rules on “failing firms” are clear, and they are strict. A merger may be allowed to occur where it
can be shown by the merging parties that the merger does not lead to a significant impediment of
competition on the relevant market. One of the factors which may be taken into account in defence of the
merger is where parties can show that due to a failing firm, which will not be taken over by any other
party, there will be a more significant impact on competition than would be the case by permitting the
merger. The merging parties must show that there is a clear probability that the target would be forced out
of the market, that the market share of the target would be assumed by the acquirer, if the target was forced

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4 Decision of the Dutch Appeal Court (Trade and Industry Appeals Tribunal) College van Beroep voor het
6 Case C-198/01, CIF, Jur. 2003, I-8055.
the requirements relating to the concept of the “rescue merger”. Monti, G. and Rousseva, E., “Failing Firms in the Framework of the EC Merger Control Regulation” (1999)
24 European Law Review 38. See also Bishop, S. and Walker, M., The Economics of EC
out of the market, and that there is no alternative acquirer available. There must be no less restrictive method available of achieving the claimed efficiencies.

To give an example, in the newspaper merger case, *De Telegraaf/De Limburger*, the NMa concluded that the proposed merger would either create or strengthen a dominant position on the readers’ market for newspapers in Limburg, and on the newspaper advertising market in Limburg. (De Telegraaf is by far the largest circulation national newspaper in the Netherlands, while the regional newspaper, De Limburger, was one of two remaining in the province). However, the NMa was faced with arguments and independent reports that the Limburgs Dagblad was unlikely to survive financially in the short to middle-term under the, then prevailing, organisational circumstances. De Telegraaf tried to use this as a failing firm defence to argue that the competitive situation on the market would be the same with the merger as without the merger. The NMa did not accept this argument. The decision points out that if the merger were to take place, a dominant position on the market for regional newspapers in Limburg would be created in the hands of De Telegraaf. If the merger were not to take place De Limburger would continue to be dominant in that market, but would be under separate ownership from De Telegraaf with whom it arguably also partially competed (i.e., there was an alternative buyer in the market). In any event De Telegraaf was unable to show that should the Limburgs Dagblad go out of business, its readership and advertisers would turn to De Limburger, and that was reason enough for the Competition Authority to reject the failing firm defence proffered by De Telegraaf. Nevertheless the lack of commercial viability of the Limburgs Dagblad did play a part in the reasoning of the NMa when it came to its assessment of the proposed remedies.

Also, under section 47 of the Netherlands Competition Act, the Minister has a formal power to overturn a negative merger decision by the NMa in a particular merger case. This is a power of last resort and has never been used. After the NMa has refused a licence for the implementation of a concentration, the addressee of the decision can request the Minister to grant the licence. The Minister may do so when in her opinion overturning the decision is necessary for important reasons in the public interest, which outweigh the expected restriction of competition. If it were to be adopted, such decision would have to be issued transparently, and the Minister cannot act alone - a cabinet decision is required.

The value of providing such a provision is that it allows a pressure valve for a time of crisis, which should preclude any call by parliament for the adoption of legislation whereby decision-making on politically sensitive mergers by-passes the Competition Authority entirely.

4. **Crisis cartels**

The prohibition on cartels enshrined in Dutch and EU law allows no express exception for so-called “crisis cartels”. However, in 2001, the NMa granted parties an exemption from the cartel prohibition under the Dutch equivalent of Article 81(3), for a limited rationalisation programme in the pig slaughtering sector. The exemption granted was only partial, extending to an agreement on capacity reduction, but refused with regard to an agreement limiting production. The parties appealed to the Dutch Court which upheld the NMa's partial rejection of the request for exemption, applying the *Weyl* case of the European Court of First Instance. The NMa follows European Community law, whereby the Commission makes it clear that agreeing prices between competitors is not an appropriate response to difficult market situations. Overcapacity and responding to dumping are also rejected as justifications for breaching the cartel prohibition. The only possible exception would seem to be where a restructuring is the primary reason for
the adoption of the restrictive agreement by which capacity in the sector is reduced and the measures proposed fall within the grounds of article 81(3) EC (equivalent to section 6(3) of the Dutch Competition Act), that is that the measures are reasonable, non-discriminatory, objective and proportionate to their goal.

A relaxation of the prohibition of cartels to allow room for crisis cartels in times of economic retrenchment could be more harmful to competition than subsidization. Firstly, cartels are a very blunt instrument and it is difficult to curtail or even to measure their impact on the market. Subsidies however can be targeted and their compliance with competition law can be tested (as outlined above). Secondly, the cultural impact of allowing cartels is dangerous. While subsidies are temporary, it is difficult to prohibit cartels once they have been sanctioned. Such prohibition may well merely result in driving the cartel underground. The NMa has had first hand experience of this phenomenon in the early years of its existence, when an outdated list of hitherto permitted cartels from the Ministry proved a fertile source of information on cartels, which were still in existence, in spite of the prohibition on cartels in the Netherlands Competition Act.

In the event of being faced with arguments for rationalization cartels, the Competition Authority should:

- firstly, point out the danger of permitting cartels in seemingly small local markets, and the knock-on effect that such cartelization policies can have at macro-level
- secondly, ensure that government, and industry is aware of the dangers of creating an inefficient, ‘fat cat’, artificially protected market, which will be ripe for takeover, if it does not take the advantage of an economic crisis, to tighten up its efficiency performance.

A de minimus rule is applicable to cartels under section 7 of the Netherlands Competition Act. The original rule related only to the number of companies involved and their turnover. This was modified in October 2007, introducing an extra escape from the prohibition on cartels, for undertakings with a small market share. Under section 7, the prohibition on anticompetitive agreements does not apply to cases where:

- no more than eight undertakings are involved and the combined turnover does not exceed euro 5,500,000 (for agreements concerning goods) or euro 1,100,000 in all other cases.

or

- the combined market share of the undertakings is no greater than 5% of the relevant market and the relevant turnover during the previous calendar year was no more than euro 40,000,000.

Debate has arisen about extending the exemption in section 7 and a decision on this issue is pending before the Dutch parliament which would relax the application of the national competition rules to small and medium sized enterprises. The proposed relaxation of the rule dates from before the onset of the current financial crisis.

It should be added, that the NMa has rules relating to the imposition of fines on companies which are suffering financial hardship. Under section 53 of the NMa’s Fining Code, the Board of Directors of the NMa calculates the fine on the basis of the Fining Code taking into account general principles of good administration. In line with Dutch administrative law, the Board may deviate from the Fining Code in the

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10 Consolidated text of the NMa Fining Code, 29 June 2007, as amended by decision of the Board of Directors of the NMa, 9 October 2007 (Stcrt. 29 juni 2007, nr. 123; Stcrt. 10 oktober 2007, nr. 196).
event that the application of the rules in the code would lead to evident inequity. The financial position of
the infringing party plays no role in principle in the calculation of the relevant fine. However, the exception
to this principle is that the application of the fine may not be such as to render bankruptcy likely.¹¹

5. Conclusion

It is very necessary for Government to consider the risk of harming long-term economic development
by revitalizing failing firms or firms in distress via protective measures by the government and
consequently putting other healthier firms at a disadvantage in their terms for competition. However,
provided Government acts transparently and proportionately, it is entirely legitimate for Government to
intervene for the common good and to protect jobs, the industry, the financial economy and so forth. That
the intervention should be “proportionate” is key. The NMa can play a role in advising Government on the
limits of its powers, on what intervention is proportionate, and what intervention is illegal and has the
function of pushing up price and excluding competition. Government is there in order to protect the
common good. So is Competition law.

1. Introduction

This paper contains the contribution of the Netherlands Competition Authority (NMa) to Roundtable 4, on the adaptation of competition rules, processes and institutions to current financial sector issues, to be held on 18th February 2009. In this paper we outline some of the lessons learned recently by the NMa concerning this issue. We stress that at times of economic crisis, it is important to maintain “business as usual” at the Competition Authority, but nevertheless to ensure that crisis measures are in place, that can be used in a timely and effective manner.

2. Background to recent events in the Netherlands

In 2007, the Belgian bank, Fortis acquired Dutch investment bank, ABN-AMRO, in a consortium with Royal Bank of Scotland and Banco Santander. The merger was notified to the European Commission, and was approved subject to remedies. The Commission found that the main overlap resulting from the merger would be in the Netherlands, in the markets of commercial banking and factoring. To address the competition concerns, remedies were offered, for example, to divest a corporate banking business, consisting of Hollandsche Bank Unie NV (HBU), some corporate client departments, 'advieskantoren' and factoring activities in the Netherlands, to a large international bank.¹

In October 2008, the Netherlands government stepped in to take over the Fortis bank’s assets, in a nationalisation package, including buying Fortis’ interest in ABN-AMRO. This action was taken after shares in Fortis had tumbled in value. This nationalisation deal replaced a previous, alternative agreement by the Belgian, Dutch and Luxemburg governments to rescue Fortis jointly.

2.1 State ownership

Governments intervene in markets in various ways for various reasons, but market failure is perhaps the primary motivating rationale. State ownership, as a form of intervention, affects competition, because the State-owned firm may benefit from the stable reputation of the State. However, State ownership may not necessarily be an asset for the target undertaking. If the State gets into difficulty at the macro-level, such ownership may become a liability. Either way, competition law applies as normal, and a merger by the State of two previously independent companies, will be treated as a merger under competition law, in the same way as it would were the parties involved stemming from the private sector.

However, the provisions of the Netherlands Competition Act require, as do their European equivalent, that the merger lead to a situation of common control, and of sustained control, before the merger is subject to notification requirements. In the case of the State’s take-over of Fortis, the measures put into place do

¹ EC Commission decisions in Cases Comp M 4843, RBS/ABN AMRO, 19 September 2007, Comp M 4845, Santander/ABN AMRO, 19 September 2007 and Comp M 4844, Fortis/ABN AMRO, 3 October 2007,
not lead to a situation of common control, and the Dutch State has made it clear that it sees the take-over as a temporary measure.

3. Sticking to business as usual

In times of economic crisis, it is important that competition authorities do not rush to adapt existing rules unnecessarily, but rather to publicise the rules that are already in place to deal with economic hardship. As explained in the Dutch contributions to Roundtables 1, 2 and 3, Dutch Competition Law already allows parties the possibility of raising the ‘failing firm’ defence in merger control cases. It is already possible for parties to a notifiable merger to request a waiver of the standstill procedure under section 46, so that in exceptional circumstances, steps may be taken to complete the merger even before clearance has been granted.

The Authority should be alert to the danger of increased cartel activity in times of economic downturn. Rather than choosing for innovation and rationalisation or merger, some undertakings may be tempted to take refuge in price-fixing or market-sharing activities when faced with threat of shrinking profits. Where a Competition Authority has been using its powers of advocacy effectively, it is in a good position, in times of crisis, to give useful advice to Ministries and branch organisations who are drawing up codes of conduct to deal with the aftermath of the economic downturn. For example, in December 2008, the NMa advised on aspects of a code of conduct for ABN-AMRO following nationalisation.

Of course, in its merger control policy, a Competition Authority should focus on macro- as well as micro-benefits. Ensuring stability has always been a crucial factor in competition law and it would be remiss of the Competition Authority to ignore this factor in its assessments.

4. Recently learned lessons

Some of the lessons the NMa has learned from the recent wave of mergers in the financial sector are firstly, the importance of establishing good contact relationships with the European Commission and with Ministries in order to facilitate speedy and good quality interaction at times of high pressure. Many of the larger financial mergers fall within the European Commission’s jurisdiction, rather than that of the national authority. If the Competition Authority is to play an effective role at such times, it is crucial that it be close to the decision-making, at an early stage.

A second lesson learned relates to the speed of decision-making in times of crisis. Where important decisions are being made in a weekend, or even overnight, it is helpful to have a crisis-team waiting in the wings, so that employees can gather at short notice to attend to an emergency situation. This involves simple administrative preparation, ensuring the availability of mobile telephone numbers of a good number of experts, so that a team of lawyers and economists with the appropriate expertise, can be assembled quickly.

A crisis, such as the recent (2008) financial crisis, exposes the value of inter-Authority co-operation. The NMa has protocols of co-operation signed up with the Authority for Financial Markets, the Dutch Healthcare Authority, and other national regulatory agencies. These standard protocols and their related periodic meetings reveal their real worth at times of economic crisis. As standard procedures are already in place, arranging increased interaction and consultation is easily done.

However, co-ordinated competition advocacy is restricted by the legal and political restrictions on interaction between authorities. Only information gathered in accordance with formal procedures may be used in a competition case. Nevertheless, there is much other general sectoral information, which may be and is exchanged between the varying regulatory instances.
5. Conclusion

The key to optimal Competition Law enforcement in times of economic crisis is to stick to “business as usual”, in so far as this is possible. This applies also to situations of Government intervention and State ownership. What we learn from recent economic events is the importance of having hardship provisions, advocacy strategies and inter-agency contacts already built in to the Competition Authority's set of available instruments so that there is no need for the adoption of reactive legislation which may, in the aftermath of the crisis, restrict the Authority in its application of Competition Law to raise consumer welfare.
NEW ZEALAND

1. **Roundtable 1: Principles: Financial sector conditions and competition policy**

1.1 How are financial markets distinct from other types of markets? In what ways might competition policy treat financial institutions and products differently as a result of these differences?

Financial markets are highly important for the whole economy, and the failure of a large financial institution would create a risk of systemic failure. Many of the wider issues are the responsibility of institutions other than the competition authority.

In New Zealand, there is sector-specific regulation of financial markets. The Reserve Bank (New Zealand’s central bank) sets prudential liquidity rules for banks, and prudential rules for non-bank deposit taking institutions have recently been added to its responsibilities. The Reserve Bank also operates the recently introduced guarantee schemes noted in Question 2.4. The Securities Commission has oversight of securities market activity. Systemically important banks in New Zealand must be locally incorporated and are therefore fully subject to New Zealand companies law and the Reserve Bank’s prudential supervision.

Although financial markets are subject to this sector-specific regulation, this in itself does not make financial services unique from the viewpoint of competition policy, given that some non-financial markets are also subject to sector-specific regulations. The Commerce Commission (the Commission) is responsible for enforcing New Zealand’s competition law, the Commerce Act 1986. The Commission has regard to the Government’s formal statements of economic policy, but it acts independently in pursuit of its mission to promote competition in markets. While allowing for any sector-specific regulations that might apply in a particular situation, the Commission does not otherwise treat financial markets in a different way from other markets.

In the past two and a half years there has been a wave of finance company failures in New Zealand. These have tended to raise Fair Trading Act questions for the Commission (i.e. whether there had been false or misleading representations by deposit-taking institutions) rather than competition concerns.

The Commission has considered a small number of applications for the clearance of bank mergers, such as the application by Westpac to acquire Trust Bank in 1996. Some other merger clearance applications considered by the Commission have involved proposals by banks to acquire insurance and investment companies. In 2003, the Commission considered an application from the ANZ Banking Group to acquire the National Bank of New Zealand. In assessing proposed mergers involving banks, the Commission applies the same analytical framework as it uses for mergers in any other sector. Since a 2001 amendment to the Commerce Act, the test is whether a proposed acquisition of assets of a business or shares “would have, or would be likely to have, the effect of substantially lessening competition in a market”.

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1 There are no government statements of economic policy in the financial sector.
1.2 Does competition promote efficiency in financial markets? How should “efficiency” be characterised in financial markets?

The underlying assumption of promoting competitive markets is that competition will promote innovation, efficiency and consumer welfare. It is expected that competition in financial markets would promote efficiency in terms of the range of products offered and their quality, and would provide competitive prices as measured by interest and fee charges.

However, some conduct by firms that is driven by intense competition might breach the provisions of the Commerce Act. Some other types of conduct involve making false or misleading representations about goods or services could breach the Fair Trading Act. The Credit Contracts and Consumer Finance Act 2003 prescribes the information consumers must be given and sets minimum standards for some contractual terms. An example is the way in which interest is calculated and charged (but it does not provide for the regulation of the actual rates of interest).

1.3 What failures of competition may have contributed to the crisis in the financial sector?

New Zealand’s exposure to the financial crisis has so far been relatively limited. This is because our banks have not had any significant exposure to the derivatives that underpinned sub-prime mortgages.

As noted however, there have been a number of finance company collapses in New Zealand over the past few years. At least 28 finance companies are currently in receivership, liquidation or are the subject of moratorium and/or restructuring proposals. These have not raised competition concerns but have been more a result of high-risk property investments and poor corporate governance. The earlier finance company failures also caused a domino effect with a loss of confidence causing other investors to withdraw their money from other finance companies.

1.4 What has been the role of competition in credit rating services, and of barriers to entry into providing those services?

This question is not relevant to New Zealand.

2. Roundtable 2: Crisis: Role of competition policy in financial sector rescue and restructuring

2.1 Should competition law be set aside in the financial sector during a systemic crisis, on public interest or other grounds? If so, how should this be done?

It should be not be necessary to set aside competition policy during a systemic crisis in the financial sector, as long as the competition authority can act quickly when needed and is empowered to consider wider economic issues. If however the Government were to include that circumstances were such as to justify setting aside competition law in relation to the financial sector, Parliament would need to amend the existing law. This was done in 2001 in the dairy sector when the enactment of the Dairy Industry Restructuring Act authorised the merger of the two major dairy manufacturers to form Fonterra Co-operative Group Ltd, thus by-passing the Act’s merger regime.

That said, particular risks that need to be guarded against are:

- The possibility of giving too much weight to short term financial sector gains and not enough weight to subsequent broader ramifications if competitive forces in financial markets are weakened; and
• Weakening competition policy and law when other better solutions might be available to deal with financial sector problems.

2.2 How should competition agencies apply general competition policy rules about mergers, anticompetitive conduct and state aid during a crisis? Is it practicable to apply failing firm doctrines to mergers as crisis actions? Is the consideration required for merger review of the financial sector during a crisis different from that required for merger review of other sectors? How should negative competitive impact on the market structure in the medium and long term be assessed in reviewing mergers required to sustain the financial system?

The main issue is whether any reduction in competition by permitting anticompetitive mergers or conduct will be outweighed by gains in the financial sector or to the economy more broadly. The New Zealand Commerce Act already permits such a trade-off to be made because:

• the Commission may authorise a merger or conduct if it considers that it will result or be likely to result in a net benefit to the public; and

• the Act requires the Commission to consider any efficiencies that may result from mergers or conduct when considering whether there is a net benefit to the public.

Another matter is that some situations may require urgent action in the public interest. In such cases, the competition authority should be ready to act rapidly in appropriate circumstances (i.e. to fast-track decisions).

In the case of merger proposals, the possibility of failure by a target company (the counterfactual situation) is part of the analytical framework applied by the Commission. This approach applies to all markets, but the possibility that more rapid assessments might be required in the case of bank merger proposals is recognised.

It is difficult to say how the negative competitive impact on the market structure in the medium and long term should be assessed in reviewing mergers required to sustain the financial system. For example, if a major bank was in danger of failing, it is hard to predict whether the Commission would judge it appropriate to balance the expected anticompetitive effects against the benefits possible from preserving financial market stability, rather than applying the existing approach to ‘failing firm’ claims.

To conclude, in New Zealand’s situation there is no reason at this time to conclude that competition law should be set aside in relation to mergers and anticompetitive conduct. There are no state aid issues in the New Zealand financial sector.

2.3 To minimise negative competitive impact to the market structure in the medium and long term, are there effective measures as remedies (e.g. temporary behavioural commitments or certain monitoring measures)?

The Commerce Act does not permit the Commission to accept behavioural undertakings when it considers clearance or authorisation applications for merger proposals. However, the Commission is able to accept asset or share divestment proposals. Monitoring measures are not favoured, both because of the resources that would be required to do this, and because monitoring would create the need to assess the impact of any changes that have occurred in the external environment since the undertaking was given.
2.4 What standards and safeguards or other provisions are needed to prevent distortions of competition when government funds are used for injections of equity or guarantees?

Guarantees have been provided recently by the Government to banks and some other financial institutions, with fees being payable. There is a two-year opt-in retail deposit guarantee scheme that was announced in October 2008, and a wholesale funding guarantee facility for investment-grade financial institutions announced in November 2008. The scheme has been designed in a way to minimise the risks that competition may be distorted if some firms are given advantages that are not available to competitors.

2.5 What lessons may be learned from how competition authorities have participated in responses to the recent crises and to previous events such as the Asian financial crisis of 1997? Are there any experiences from past financial crises in which measures for emergency response to the crisis in the short term, like mega mergers in the financial and other business sectors, caused greater harm to the competition in the medium and long term?

This question is not relevant to New Zealand.

3. Roundtable 3: Real economy: Challenges for competition policy in periods of retrenchment

3.1 What should be the position of competition agencies towards subsidies to ailing firms or sectors? How should they respond to efforts to protect national champions and obstruct acquisitions by foreign investors?

The extent to which competition agencies involve themselves in such matters depends on the limits of their statutory powers and whether involvement or competition advocacy would be consistent or inconsistent with their independence status. They should of course respond to requests from government agencies that are considering granting subsidies for assessments of the likely impact of such activities on competition.

3.2 How should competition rules apply to acquisitions of failing firms or firms in distress, in the current financial market conditions? How should negative competitive impact on the market structure in the medium and long term be assessing reviewing mergers or state aid?

As noted above, in relation to Question 2.2, the possibility of failure by firms should form part of the analytical framework used to assess merger proposals.

There is no legal doctrine in New Zealand as to what constitutes a ‘failing firm’, and each case is assessed separately on the facts. The factors that the Commerce Commission would take into account when it considers a failing firm argument are:

- The actual, imminent or probable failure of one firm in the proposed merger,
- That there is no prospect of restructuring or re-financing the business. On closure, the assets will exit the market, either becoming scrap, or being put to and alternative use, and,
- There are no other purchasers for the business, despite reasonable attempts to find one.

At times, the issue might be an allegation that a division of a company is failing, as opposed to an entire firm. Assessing whether a division of a firm is in “actual, imminent or probable failure” is a more complex task, given the scope a parent firm has to allocate costs, revenues and intra-company transactions in a range of ways.
Broadly, the Commission’s position is that a failing firm claim would require rigorous examination, and that, before it could consider accepting such a claim, the Commission would need to be certain that there are no less anti-competitive alternatives to a proposed acquisition.

In the absence of any specific policy measures by Government related to a financial crisis, the Commission would apply the same processes of analysis as outlined above, but would recognise fully the need for urgency.

3.3 Will tightening financial markets create barriers to entry and expansion in the real economy? If so, how should competition enforcement respond?

The tightening of financial markets could create barriers to entry and expansion if the effect was to cut off previously available resources of equity and loan capital for investment. A competition authority would be unlikely to have any power to reverse this situation (other than, where permitted to do so, to undertake advocacy activities). However, the higher barriers should fully be taken into account in the analytical frameworks that are applied to the assessment of proposed mergers and of the unilateral use of market power.

There has been a sharp decline in merger clearance applications in New Zealand recently, following the financial downturn. This is presumably partly because of a tightening of credit availability from the financial sector, and partly because of a ‘wait-and-see’ attitude amongst potential acquirers.

3.4 How should competition policy respond to proposals for modern versions of “depression” or “rationalization cartels” and similar schemes? What lessons can be drawn from previous crisis-driven policies to reduce competition, such as the self-regulation that was encouraged during the depression of the 1930s?

The Commission has not been required to consider this issue in recent years. However a Commission decision in 1987, involving the meat processing industry (a relatively large and, at that time, declining industry in New Zealand), has some relevance. In Decision 205 the Commission authorised a collective agreement between five meat processing companies to give effect to an agreement that included the permanent closure of two meat processing plants. The Commission found that the arrangement would cause some loss of competition, although relatively limited in extent, but that there would be significant benefits. A key benefit was found to be the lowering of costs, particularly fixed costs, in a situation where over-capacity imposed significantly higher costs on the industry. The Commission found that the agreement would preserve a major processor in the market, and it noted an expert view that industry rationalisation “will ensure that a major export industry does not continue down the path to a ‘sunset’ industry.”

3.5 Is it necessary to consider the risk of harming long-term economic development by revitalizing failing firms or firms in distress via protective measures by the government and consequently putting healthier firms at a disadvantage in their terms for competition?

It is imperative to consider the impacts on long-term economic development of policy measures designed to assist firms in distress. First-best responses would be policy changes that address the long term drivers of productivity while avoiding distorting incentives in the economy and, to the maximum extent possible, are applicable to the general business environment. Any impacts on competition or competitive frameworks should form part of the advice to governments on possible policy interventions.
4. Roundtable 4: Going forward: Adaptation of competition rules, processes and institutions to current financial sector issues

4.1 What have competition agencies learned from merger decisions in financial services sectors?
How have they dealt with interactions between, and evolution of, financial markets?

The Commission has not encountered any problems resulting from its decisions on merger proposals in the financial services sector. In its examination of the structure of any market, the Commission takes account of current and likely future changes in the nature of the market, and is not bound by earlier market definitions. The Commission’s past consideration of clearance applications from banks and other financial institutions, noted briefly in the response to Question 1.1 above, have not led to any concerns that are unique to the financial services sector.

In September 2003, in its Decision 507, the Commission agreed to the acquisition by the ANZ Banking Group (NZ) Ltd of all the shares and assets of the New Zealand holding company of the National Bank of New Zealand Ltd. At that time, New Zealand had five major full service banks that together controlled 84% of the assets of all registered banks operating in New Zealand. The two banks in the proposal were the second and the fourth largest in New Zealand, and the acquisition would have resulted in market shares outside the Commission’s safe harbours in the relevant markets. In its analysis of the proposal, the Commission identified 19 relevant markets. It found that there were no concerns about the likely effects on competition in the majority of these markets. In two of the markets: the supply of transaction accounts and the supply of banking services to the SME sector, the Commission found that there could be some reduction in choice and in the quality of service, but that these effects would not be substantial because of the competition provided by the three other major competitors.

4.2 How can competition policy seek to improve competitive conditions in the financial sector, such as by reducing switching costs or improving the availability of credit data?

Competition policy has a role to play in enabling consumers (both lenders and borrowers) to exercise choice and switch financial providers in response to differences in products, price and service. This is achieved by reducing barriers to competition such as switching costs, which can vary depending on the nature of the contractual agreement and the length of agreement term. Competition policy can also improve the availability of information for consumers and providers. The Ministry of Economic Development is currently leading some work on positive credit reporting, which could provide a smoother flow of credit information for providers allowing consumers to switch providers more easily. Consumers also need to be fully informed and understand the nature of the agreements they are entering into. As noted in the response the Question 1.2, the Commerce Commission enforces the Credit Contracts and Consumer Finance Act which requires consumers to be provided with certain information and for minimum standards for contractual terms to apply. In relation to the finance sector, the Commission has taken enforcement action under the Fair Trading Act against trading banks that failed to disclose the full extent of the charges applicable to foreign exchange transactions. Refunds to bank customers resulted from this.

4.3 Should competition authorities extend the conception of consumer welfare to include macro-economic benefits from ensuring system stability?

The Commerce Act is flexible enough to take into account possible macro-economic benefits of ensuring system stability. The Commerce Act states that the purpose of the Act is to promote competition in markets for the long term benefit of consumers. In addition, the authorisation process referred to in response to Question 2.2 above allows the Commission to authorise a merger or restrictive trade practice if it is satisfied that the proposal is likely to be of net benefit to the public. This public benefit test allows any
benefits to be taken into consideration, including the macro-economic benefits from ensuring system stability.

4.4  How does state ownership affect competition? Should bringing a number of individual firms under public control be treated as a notifiable “merger operation”?

The Commerce Act applies in full to the Crown and Crown-owned corporations. In addition, for the purposes of the Act, separate Crown entities are regarded as separate legal entities notwithstanding their common Crown ownership. For example, there are three Crown-owned electricity generation companies in New Zealand and they must compete with each other. Thus, the Act applies in full to state-owned enterprises that are engaged in trade as to privately owned enterprises. Consequently, if two or more competing financial sector firms were brought under state control, the Commerce Act merger and trade practices prohibitions would apply in full.

As New Zealand has a voluntary merger notification regime, there would no legal requirement for the Commission to be notified if there were proposals to bring individual firms under public control. However, the Government might choose to seek advance clearance or authorisation from the Commission for the transaction. Another option would be for the Government to introduce legislation that would exempt the acquisitions from the scope of the merger provisions of the Commerce Act. If the transactions went ahead without a specific legislative exemption, or an application for clearance or authorisation, the Commission would have the power to investigate the effects of the merger, and to take enforcement action if the effects on competition appeared to make this appropriate.

4.5  On the relationship between financial sector regulators and competition authorities:

4.5.1  How does the role of competition agencies interact with the role and remit of authorities and regulators responsible for financial services, securities and commodities exchanges, monetary policy, financial stability and accounting standards? What should be the respective responsibilities and scope of coordination between competition agencies and these regulators? Should competition agencies develop in-house expertise about financial markets?

In practice, the Commission has found that its work has required little or no interaction with other agencies with regulatory responsibilities in this sector.

4.5.2  What are the legal and practical impediments to competition agencies and financial sector regulators sharing information and market analysis and working together to formulate policy initiatives and interventions? How best can competition agencies engage in coordinated competition advocacy?

A possible impediment to co-ordinating activities between agencies, including financial sector regulators, is the need to protect confidential information that each agency has received in relation to an issue. It would generally be necessary to obtain the consent of the providers of such information before it could be shared with another agency.

4.5.3  As institutions for overseeing and regulating financial markets are improved, how can the policy goals of market competition and financial system security be best co-ordinated?

In general, New Zealand adopts a whole-of-government approach to policy development and a number of projects require cross-agency coordination. In relation to regulating financial markets, there is the Financial Regulators’ Coordination Group which is a forum amongst various New Zealand government agencies for sharing information and views about regulatory issues, financial system developments, other matters of mutual interest, policy issues of common interest, areas of overlapping responsibility and

To further coordinate policy goals, one approach would be for institutions to provide written opinions on how measures proposed by other agencies would be likely to impact on a particular market. Because the authority of competition agencies to undertake advocacy varies between jurisdictions, this might be done by invitation in some jurisdictions, and on a pro-active basis in others.
SWEDEN

The Financial Crisis in Sweden in the 90s – Useful Experiences for Today

Sweden experienced during 1991-1993 a financial crisis which had some features in common with the current global financial crisis. Some components were however unique for the Swedish market and for its time. Different from the current global crisis, the Swedish crisis was local. It was based on bad loans, in particular real estate, and reinforced by a currency crisis and fiscal crisis.

Below follows an article published in 1996 by Stefan Ingves, the Governor of the Riksbank (the Swedish National Bank) and Göran Lind, Senior manager of the Riksbank. The article, “The management of the bank crisis – in retrospect” has been widely used to describe the crisis in Sweden.

The authors stress the importance of transparency in order to restore confidence. Although losses are severe, lack of confidence is probably the most serious problem. There must be transparency about instruments, solutions and valuation, by authorities as well as by market participants. Resolution requires a clear and predictable framework, supported by broad political majority. And there must be flexible solutions for different bank situations. The authorities that are involved must have clear mandates and roles. Government takeover of banks can be considered as a temporary solution.

To conclude, the previous crisis of the 90s has generally been considered as a useful experience to tackle the problems of today.
The management of the bank crisis – in retrospect

By Stefan Ingves and Göran Lind

What methods were chosen by the Swedish authorities to resolve the bank crisis? Why did they choose these methods rather than others, for instance those that had been tried elsewhere? Can the degree of success with which the bank crisis has been tackled be judged retrospectively?

A number of guidelines that have been used to handle the banks’ problems are described in this article.

During the bank crisis in Sweden Stefan Ingves, now Deputy Governor of the Riksbank, was head of the financial markets department at the Ministry of Finance before he was appointed Director General of the newly established Bank Support Authority. Göran Lind, Senior Manager at the Riksbank, was answerable to the managing body for the Riksbank’s handling of issues to do with bank support. This article is based on material that has been used in international seminars, for instance under the auspices of the International Monetary Fund and the International Bank for Reconstruction and Development.

Crisis no longer acute

The Swedish bank crisis is over. A massive cleaning-up operation remains and it mainly involves managing and disposing of the large stocks of real estate and other assets that the banks were obliged to take over to protect their claims. The difficulties and the magnitude of this task should not be underestimated but unlike the situation during the crisis, it does not threaten the banks’ survival. Good news now has the upper hand. In 1995 the banks reported group profits totalling around SEK 18 billion. The level of loan losses for many of the banks is now below 1 per cent of their loan stock, which must be considered acceptable. Solvency (capital adequacy) is high even in an international comparison.
The bank support can be ended

In 1994 and 1995 bank group profits totalled around SEK 15 billion. The Financial Supervisory Authority has undertaken a thorough assessment of all the 114 banks (of which 90 are savings banks) and other credit institutions that are covered by the State bank support guarantee from December 1992. The Authority has found that the institutions are now so strong financially that the bank support can be ended without jeopardising the stability of the financial system. The Riksbank shares this opinion. A proposal to end the guarantee with effect from 1 July 1996 will be presented in a bill to the Riksdag this spring. A system for protecting deposits, financed by the banks, was introduced at the beginning of 1996.
Numerous inquiries into and analyses of bank crises have been undertaken in recent years. Besides covering the crisis in Sweden, they have looked at problems in the banking sector in other countries, for instance the Nordic group, the United States, Japan, the United Kingdom and France. The problems in these countries have many features in common but the methods for tackling them have varied. There are several explanations for this, for instance the political and economic situation in each country, the perceived roles of the State and the owners and so on.

The methods for resolving the Swedish bank crisis were chosen initially on an ad hoc basis because remedies had to be found without delay for acute situations that at first seemed to be confined to a couple of banks where large sums of money as well as credibility were at stake. When it then became clear that the crisis was systemic, a matrix of alternative solutions was constructed. There were certain basic guidelines as well as room for flexibility because the problems tended to differ from bank to bank and the solutions had to be adapted accordingly. Looking back, a number of guidelines can be discerned in the management of the bank crisis.

Guidelines in the management of the crisis

**Political consensus**

Broad political support for the measures was important. If the political parties had disagreed about the support measures, not only would the latter have been delayed but the disagreement would also have attracted attention abroad, with serious consequences for the efforts to restore confidence in Sweden’s financial system. Negative effects clearly resulted in some other countries where a political consensus on the management of the crisis was not achieved. Two of these effects are higher financing costs for the banks and decreased access to loans in the interbank market.

A political consensus in Sweden was promoted in various ways. Openness was highly important and included information to the general public from the Government and the authorities concerned (see “Enhancing Confidence” below). In order to prevent the bank support from becoming a source of political disagreement, the Government declared that it was prepared to share information about the support issues with other parties. The political opposition was also represented on the board of the Bank Support Authority.
ENHANCING CONFIDENCE

Openness and information to the general public are highly important. In the autumn of 1992 confidence in the Swedish financial sector was low in Sweden as well as abroad. The most negative effect of this was a reduction in the supply of foreign credit. Besides affecting the banks and their borrowers, this had a general economic impact by generating a substantial net outflow of foreign exchange. The Government did manage to check this outflow by greatly increasing its borrowing abroad but this further curtailed the banks’ external borrowing facilities. The Government and Riksbank concluded from this that a country, like Sweden, that is heavily dependent on external credit must restore confidence more quickly and vigorously than countries whose external position is stronger, such as Norway and Japan. This influences the choice of methods for tackling the problems.

The Riksbank approves the bank support guarantee on 18 December 1992.

The need for strong measures to enhance confidence led to the “bank support guarantee” that the Riksdag approved in December 1992. An important aspect of this guarantee was that, except for the shareholders, it protected all the banks’ creditors. No upper limit was set for the State support. As confidence in the solvency of the State was unbroken, creditors could continue to provide Swedish banks with funds without risking losses.

The Riksdag’s decision had to be followed up. The content of the support and the specific measures that were being planned to tackle the banks’ problems were not known abroad. The need to spread this knowledge led to a whole range of information activities. Cabinet ministers and officials, mainly from the Ministry of Finance and the Bank Support Authority, made frequent visits to financial centres around the world to describe the situation and the measures that had been and would be taken. This was accompanied by a similar dispersion of information in Sweden.

The confidence-enhancing measures succeeded. The higher prices that Swedish banks were forced to pay for credit fell back relatively soon to a normal level. The inflow of credit turned upwards and stabilised at a satisfactory level. Swedish banks admittedly had their credit ratings lowered but not so much that financing could not be arranged.

Concerning confidence in the banks, it should be mentioned that at no time during the bank crisis – not even before the Riksdag approved the bank support – was there any serious distrust in the sense of a very large withdrawal of deposits.
In certain cases withdrawals were larger than normal for brief periods but the situation remained under control and there was no risk of a liquidity shortage.

**Openness**

Openness is a wider concept than information. It involves refraining from concealing both the extent and the nature of the problems. The practice of booking loan losses and valuing assets is not an exact science. The room it leaves for discretion enables banks and other firms to vary the picture of their financial position without breaking the law. One example of accounting flexibility, though this has been markedly curtailed in recent years, is the valuation of real estate as a long-term holding or at a current market value. In certain cases the question of when a loan loss can be said to have occurred, so that it is included in the bank’s profit and loss account, is also a matter of judgement.

Two alternative methods have emerged in international discussions of banking problems. The first method involves deferring losses for as long as is legally possible and using the bank’s current income for a gradual write-down of the loss-making assets. One advantage of this method is that it helps to avoid the bank being forced to sell assets, usually below their cost price. A serious disadvantage is that the method presupposes that the problems can be resolved relatively quickly; otherwise the difficulties soon mount up, leading to very much greater problems when these ultimately materialise. The handling of problems among savings and loan institutions in the United States in the 1980s is a case in point.

With the other method, an open account of all the expected losses and write-downs is presented at an early stage. This clarifies the extent of the problems and the support that is required. Provided the authorities and the banks make it credible that no additional problems have been concealed, this procedure also promotes confidence. It entails a risk of creating an exaggerated perception of the magnitude of the problems, for instance if real estate that has been taken over is valued unduly cautiously in a market that is temporarily depressed. This can lead, for instance, to borrowers in temporary difficulties being forced to accept harsher terms, which in turn can result in payments being suspended.

The Swedish authorities opted for the second method: disclose expected loan losses and assign realistic values to real estate and other assets. This method was consistent with the other basic principles for the bank support, such as the need...
to restore confidence and to place the banks’ accounting principles on an equal footing in order to make a fair assessment of their need for support.

The Financial Supervisory Authority tightened its rules for the definition of probable loan losses as well as for the valuation of real estate. In order to obtain a more uniform valuation of the real estate holdings of banks applying for support, the Authority also set up a Valuation Board with real estate experts.

Looking back, it can be said that in general the level of valuations was realistic. The real estate holding companies that were established by the banks on the basis of these valuation principles are yielding a direct return that is close to the market rate.

**Organisation and division of labour**

At an early stage in the bank crisis it was already clear that the Ministry of Finance was not equipped to manage broad support for the banking system. The current legislative tasks of the Ministry would be crowded out and its staff did not possess all the various qualifications that were needed for analyses and negotiations with the banks. Assigning the bank support operations to the Riksbank or the Financial Supervisory Authority was not considered appropriate because this might conflict with interests involved in other operations of these authorities. It was therefore decided to establish a new authority, the Bank Support Authority, to manage the bank support under the Ministry of Finance.

The Government assigned limited organisational resources to the Bank Support Authority. In order to avoid duplication, the expertise of the Riksbank and the Financial Supervisory Authority was utilised by arranging for a continuous and mutual exchange of information. These authorities were also given a statutory right and duty to consult with the Bank Support Authority on all important issues to do with the support. Moreover, the Bank Support Authority made considerable use of Swedish and foreign consultants, most of whom already had experience of bank crises in other countries, such as the United States and Norway. The consultant services were costly (and were paid for by banks applying for support) but as the corresponding expertise and capacity were not available in other ways, they conferred the essential benefit of saving time. The network established in this way proved to be effective; decisions in support cases could be
made at the very short notice that the acute nature of the measures often called for.

As an acute lack of liquidity, particularly in foreign exchange, was a feature of the bank crisis on a number of occasions in the autumn of 1992, in the course of its normal operations the Riksbank took steps to secure the financial system's stability. As described in the Bank's annual reports, this included sizeable short-term lending in the domestic as well as foreign currencies and depositions in the banks. The loans and deposits were arranged at normal interest and repayment terms. In that the State guarantee protected bank creditors, there was no departure from the Riksbank's principle of confining its loans to solvent banks. The measures for supporting liquidity functioned as intended; after a short period the loans and deposits could be terminated.

**A COMMON YARDSTICK**

Objective criteria were needed for the treatment of banks applying for support. A basic approach in the assessment of the support - its size and forms - was to construct probable scenarios for future development in the light of known and forecast data on a bank and its financial and economic environment.

The bank were then assigned to one of three categories: A, B or C.

- An A bank was liable, in the worst case, to deteriorate towards the capital adequacy limit of 8 per cent but would subsequently be able to restore solvency. The problems of an A bank ought to be solved by its shareholders, possibly aided by some form of temporary guarantee from the Bank Support Authority in order to underpin confidence in the bank.

- A B bank might fall below the 8 per cent limit for a time but fulfill the capital adequacy requirement again later on. This, then, was a bank with short-term problems but a good prospect of future profits. Such a bank might need more extensive State support, including capital contributions or loans, if its owners were not capable of providing sufficient capital. In a macroeconomic perspective the bank's survival would still pay because the scenario indicated long-term profitability. A case in point was Föreningsbanken, where the owners were prepared to make capital contributions that would ensure a ratio above 8 per cent. This presupposed, however, that the uncertainty about the medium-term development of the bank's financial position was reduced; this was achieved in that the Bank Support Authority provided a temporary safeguard whereby a capital contribution from the State would be forthcoming if the capital ratio fell towards 8 per cent.
A C bank was one that, according to the scenarios, would most probably never become profitable again; its capital would be gradually eroded and ultimately become negative. In such cases, e.g. Gota Bank, the State needed to take appropriate measures in order to minimise the macroeconomic losses. This did not necessarily entail the bank’s liquidation; in certain cases a more favourable result could be achieved with other methods, such as selling off bad assets and then selling, or merging, the remainder of the bank.

Irrespective of the category in question, the Bank Support Authority operated on the basis of certain “truths” about loss management. Firstly, a capital loss has to be covered – in one way or another. This “unpleasant truth” tends to be disregarded in the debate on bank support issues, in Sweden as well as elsewhere. The analysis becomes much easier if the parties can agree on the existence of a hole in a bank’s capital that must be filled. Secondly, as a general rule the economic value of a bank to an investor is the present value of its future profits. From these two truths it follows that if the capital loss is too large in relation to the present value of profits, then no private investor will be prepared to contribute sufficient capital on economic grounds. Even in such
cases, however, the provision of State support may be economically defensible, partly because this may reduce the final loss, e.g. by avoiding a forced sale of assets at less than cost price. Moreover, a controlled wind-up of problem banks tends to enhance confidence, which is socially beneficial.

This analysis also implies limitations on the terms for repayment of State support by a bank that is wholly or partly owned by the State with the intention of being privatised. As mentioned above, the total value that can be extracted from a bank is represented by the present value of future profits. If the State stipulates future repayments from the bank, its sales value will be correspondingly lower. With unduly stringent repayment terms, the bank becomes impossible to sell.

The scenario method clearly requires that the banks’ assets and liabilities are valued and accounted for in a uniform manner (see above under Openness). It also involves the construction of a “bank model”, using large quantities of data from bank balance sheets as well as general economic data on interest and exchange rates, the level of activity and so on. This model made it possible, for instance, to examine the sensitivity of bank profits to different economic scenarios.

**Work-out units**

The sizeable volume of non-performing loans in certain banks, as well as their legal and technical complications (e.g. real estate that needed renovating prior to sale), made it appropriate to transfer these loans from the regular operations to separate work-out companies. Examples of such companies in the context of the bank support are Securum and Retriva. Banks that did not utilise the bank support have also established similar entities in their organisation, e.g. S-E-Banken’s Diligentia and Handelsbanken’s Närkebro.

These items should be separated from the other operations for several reasons. The bad loans tend to call for specialists, e.g. in liquidation procedures and real estate management, who are not available in regular banking operations. The management of these loans also differs from the handling of normal credit. Separate organisations for regular operations and for the management of bad loans is therefore a rational arrangement. It probably also helps to clarify the economic incentives, with appropriate performance targets for the healthy operations and the work-out unit, respectively.

Sizeable resources were set aside under the bank support to create and capitalise Securum and Retriva. Nordbanken’s bad loans were so massive that
although support measures had reduced the financial risk, they would probably have retarded a recovery if they had been left in the bank. A transfer of non-performing loans and other commitments was therefore made to Securum for SEK 50 billion (after write-downs) and Securum received a capital contribution of SEK 24 billion to cover its costs in the work-out period. In Gota Bank the non-performing loans were very large in relation to total assets (over 45 per cent). The scenario analysis showed that the bank could not become viable in the longer run, making it necessary to separate the bad loans in order to sell the healthy part of the bank. Non-performing loans and other assets were sold to Retriva for a net value, after write-downs, of SEK 16 billion (39 billion before write-downs). The State also provided Retriva with a capital contribution of SEK 4 billion.

The transfer of bad assets to a work-out unit should be made at a realistic market price. A fair valuation is important when bad assets are transferred to a work-out unit. The assets should be made over to the unit at a realistic market price. Besides involving the principal of openness, the valuation should establish a proper incentive for the management of the assets. Confidence in the State's bank support would also be impaired if the value assigned to the assets turned out to be too high, making it necessary to contribute additional capital, possibly more than once.

Diagram 4. Non-performing loan stocks of Nordbanken and Gota Bank
Per cent and SEK billion
**Equity capital**

The initiation of measures of State bank support calls for clear guidelines concerning the treatment of the existing owners’ capital inputs. This is necessary for several reasons:

- To give the owners a clear perception of their position in negotiations with the State.
- To avoid undue utilisation of government funds.
- To show the taxpayers that the banks’ owners are not being favoured at their expense.

It was already clear when the Riksdag approved the bank support that shareholders were not to receive the protection afforded to depositors and other creditors. In its discussions with banks applying for support the Bank Support Authority made it clear that to the extent that capital or other financial support was provided by the State, this would entail a corresponding reduction in the share capital of the bank’s earlier owners. This principle is clearly exemplified in the agreement (which has not been activated) with Föreningsbanken, which stipulates that the State is to receive the equivalent of any capital contribution in the form of preference shares. The voting power inherent in these shares would grow over time, which means that if the support were to be utilised on a large scale over a long period, then the State would gradually acquire a majority holding.

A law was passed to enable the State to undertake the compulsory redemption of shares, following their valuation by an impartial body. The purpose of this law was to ensure that necessary measures for protecting a bank, perhaps with considerable economic assets at stake, could not be obstructed by a group of shareholders trying to use the situation to get more than the market price for their shares. The law, however, has not been used.

**State ownership**

Right from the start it was stated explicitly, for instance in the Riksdag’s decision in 1992, that the bank support was not to result in the State becoming a long-term owner of banks. In so far as State ownership of a bank was necessary as a temporary measure, the aim should be to privatise the ownership as soon as this is feasible in a manner that is economically sound (as in the case of the plans for Nordbanken).
CONDITIONS

Conditions were attached to the support that banks received. They usually concerned measures that were needed to rectify flagrant shortcomings in earlier operations. A more appropriate and, at the same time, less costly organisational structure might be required, for instance, or better internal controls and risk management. Compliance with the conditions could be ensured in that State representatives were appointed to the boards of banks receiving support.

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The State never set out to influence the regular operations of the banks. The support was confined to the financial requirement for a bank’s survival, while its operations as such remained the responsibility of the bank management and board of directors.

GOAL FOR THE STRUCTURE OF BANKING

In the reconstruction of banks, the authorities had some general ideas about a desirable future structure of the banking sector. One important notion here was that with a number of banks with a solid future, active competition could be maintained. The merger of Gota Bank with Nordbanken was in keeping with this idea. The reconstruction of Swedbank and Föreningsbanken and their transformation into limited banking companies gave their ownership a stronger structure; in these cases the initiative came from the banks but it was furthered by the need to secure their capital base.

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The crisis recedes

The bank crisis did not become as serious as many had feared when the situation was most precarious in the months around the turn of 1992. Confidence in Sweden’s financial system soon stabilised after the Riksdag approved the support. The financial position of the banks gradually improved in 1993 and their losses declined. Two banks – Swedbank and S-E-Banken – that had applied for support at the beginning of 1993 reported in the summer that their owners would be contributing additional capital and they therefore discontinued the discussions with the Bank Support Authority.

Föreningsbanken has not had to activate the capital adequacy safeguard it obtained and its group capital ratio is now at the satisfactory level of 11 per cent.

Much of the State’s financial support to Nordbanken/Gota Bank can be recovered by means of privatisation and share dividends because good profitabil-
ity has now been restored. Substantial amounts can probably also be recovered from Securum and Retriva after the disposal of their assets.

In that the banking crisis has been overcome more rapidly than expected, it seems reasonable to suppose that the guidelines for resolving the crisis have had a favourable effect. This assumption is supported by the observation that the choice of different methods in other countries – for instance not to disclose the full extent of the problems – has accentuated instead of diminishing the difficulties. But regardless of the extent to which the choice of methods may have helped to resolve the crisis, there is an additional factor, not mentioned above, that has been crucial, namely macroeconomic development. After the turbulent situation in the autumn of 1992, the Swedish economy has become more stable. Measures were taken to reduce the Government deficit, interest rates fell and exports grew rapidly, partly as a consequence of the krona’s depreciation. All this benefited the banks by raising their operating income and reducing loan losses as the solvency of many borrowers improved. The conclusion is clear: just as the acute phase of the bank crisis was triggered in part by macroeconomic unrest towards the end of 1992, so has the recovery in the banking sector been aided by the economic improvement from 1993 onwards. Without a sound national economy, measures to support the banking sector have only a limited effect.

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Was the bank support necessary?

Did the bank support call for such an extensive framework? Riksdag decisions on guarantees and unlimited amounts, the establishment of a new authority, the detailed scrutiny of banks applying for support, and so on? Could the crisis have been managed more simply and cheaply? Such questions must be assessed in relation to the situation as it was in the autumn of 1992. Confidence in Sweden’s financial sector, as well as in its currency, was very weak. There was a massive outflow of foreign exchange. A deep recession was in its second year. Asset prices had collapsed and the loan losses of banks had rocketed. There was an evident risk that the capital ratios of all the major bank groups, possibly with an isolated exception, would soon fall below 8 per cent. The law requires that in that case the authorities withdraw the banking permit (oktroj). A very acute problem had to do with the banks’ dependency on sizeable and continuous foreign currency borrow-
ing, in that their international counterparties had already begun to curtail or even close credit facilities on account of uncertainty about the solvency of the Swedish institutions.

In this situation the Government and the authorities concluded that without a prompt restoration of confidence in Sweden and its financial sector, the stability of the payment system was clearly threatened, which would probably have highly adverse consequences for the economy as a whole. In order to avoid this, the measures the Government chose to implement needed to be so clear and far-reaching that a strong determination and ability to tackle the problems would be immediately clear to the rest of the world. There was neither time nor scope for more than an approximate assessment of what the situation called for.

The bank support has contributed to a banking system in Sweden that is now financially robust, dynamic and competitive. As discussed above, the effects of the bank support and whether alternative solutions would have yielded different results cannot be gauged more closely in retrospect. Sweden now has a banking system that is financially robust, dynamic and competitive. The overall economic structure is thereby strengthened in various ways. The support measures have accordingly helped to fulfil the primary long-term objective.
1. **Summary**

- In financial markets, there are **risks of market failure** due to externalities and information asymmetries. A run on one bank can cause other banks to fail. This could lead to disruptive evolutions for **the economy as a whole**.

- Such events set aside, financial markets are not fundamentally distinct from other markets. They work based on a **free market system as other sectors** with generally a sufficient number of agents on both sides. Competition is intensive: Entry barriers are relatively low, where scale matters, financial markets are usually globalised, and technical progress made trade with financial services easy.

- The risks of market failure are to be tackled by **sector regulation**. **Within the boundaries of sector regulation**, competition is a perfectly adequate means to enhance efficiency and maximise welfare. Financial institutions should in principle not be treated differently by competition policy than any other sector.

- The Swiss Cartel Act (ACart) is therefore also **applicable to financial institutions** reflecting a conviction that the most promising competition policy in financial services is **not to distort competition but to guarantee a free market for everyone who wishes to offer financial services** within the normal restrictions laid down in competition legislations such as merger control.

- Competition authorities shall **focus exclusively on the analysis of effects on efficient competition**. An expansion of the agencies’ analysis would weaken the focus on competition policy. With respect to systemic risks, separation of tasks between regulatory agencies is considered useful. Competition should not be blamed for risks of market failure. Rather, if market failure risks become apparent, there is **scope for reform of sector regulation**.

- In Swiss cartel legislation, two provisions are related to the peculiarities of the sector: Art. 9 (3) ACart concerning the calculation of turnover and Art. 10 (3) ACart, attributing priority to creditors’ interests in the event of a forced bank merger. Art. 10(3) ACart reflects the fact that in extraordinary situations, **extraordinary measures may be necessary** to restore working markets. In such situations, **competition policy should not be set aside** in order to prevent large distortions of competition. Exceptional measures must be proportional, they should be non-distortive and temporary (to the extent that this is possible in merger cases).

- **State ownership should be avoided but cannot be excluded** when it comes to re-establish functioning credit markets. Given the political difficulties to devise and set into force an exit strategy, other instruments to improve bank balance sheets on the event of a crisis need to be examined.
• **Competition can also be distorted by formal or informal state guarantees.** They have potentially the same effect as state aid and lead to moral hazard problems. Based on the experience of the ‘90ies, federal banking supervision was extended on banks owned by sub-federal entities, and privileges for these banks curtailed.

• **Actions taken in fall 2008** in order to support the banking system in Switzerland were in line with the principles outlined in this paper.

2. **Principles: Financial sector conditions and competition policy**

2.1 *How are financial markets distinct from other types of markets? In what ways might competition policy treat financial institutions and products differently as a result of these differences?*

In principle, financial markets are not very distinct from other markets, such as markets of goods. They also operate on a free market supply and demand system. However, financial markets have some peculiarities that do not exist or not in such a distinct manner when compared to other markets:

• **Risks of market failure, interdependences and market imperfections**

Financial services markets are subject to potential market failures. An important potential market failure is caused by **externalities**: If a large bank stumbles – for example due to management failures – this will not only affect the directly involved company. The large banks’ largest creditors are usually other banks. Therefore, liquidity problems of one bank can also drive other, technically healthy banks into illiquidity. If a large enough bank is threatened by illiquidity, the risk becomes systemic, endangering the whole banking sector.

Finally, even the whole monetary supply is at stake if the role of the banks as financial intermediaries does not work properly anymore. An important point in this respect is the very high interdependence among financial institutions and capital lending. If the banking sector is not working well anymore, the credit volume is at stake and the transmission mechanisms of monetary policy could no longer function properly. Both will affect the whole economy heavily.

The capital structure of banks is heavily dependent on borrowed capital, so that not even factual liquidity problems are necessary to cause liquidity problems. Mere rumors of insolvency can lead customers to withdraw so many funds from their accounts that the bank becomes illiquid within a very short period of time, even if it was technically healthy shortly before. To avoid a crisis in trust can be essential.

Another issue are market imperfections due to **information asymmetries**: It is impossible for a regulator to be fully informed and to anticipate the risks that a bank takes. Even complete data sets and the most sophisticated risk management within a bank cannot perfectly estimate financial market risks ex ante. Therefore, the risk of liquidity crises can only be minimized, but it can never be completely excluded, creating the need for a lender of last resort.

To minimize market failure risks is the task of **sector-specific regulation**. Both sector regulation and the enforcing agencies have to set boundaries (e.g. minimum equity capital or underlying capital) to prevent the market failures that were described above. In order to limit risks, the State intervenes through regulation (e.g. Basel II), and sets up surveillance, in the case of Switzerland the Swiss Financial Market Supervisory Authority (FINMA) supported by the Swiss National Bank (SNB). They apply their specific instruments such as stress tests.
Once these boundaries are set, competition can usually work as on other markets and in this respect, financial services markets are as special as other regulated markets.

- Technical development

  Compared to trade in goods, trade with money, respectively with capital, can be handled in a simpler, quicker way, and with less transaction costs, both on a national or international level. This holds particularly true since the evolvement of modern information and communication technology.

- Globalisation effect

  By the application of information and communication technology, financial markets become more global and should in principle become “deeper” as well. On the other hand, this allow for a crisis to spread faster from one national market to another national market than in markets of goods.

- Customer mobility

  On financial markets there is a wide offer of intermediary services compared to the one proposed on markets for goods. Banking in itself is intermediation. This goes hand in hand with lower transparency and information asymmetries for customers, a factor normally compensated for by the risk reducing effect of bundling loans. At the retail level, customer mobility is reduced by the high confidence financial institutions need, by information asymmetry, by the excessive administrative burden tied to a change of financial institution, by high closing charges and often also by low price transparency and cross-selling or bundling of products.

- Incentive system

  Particularly in intermediate services within the financial sector, and most notably in investment banking, the financial sector stands out by the incentive systems used to attract staff. High bonus payments to employees tended to favour risk-seeking behaviour. Mobility in geographic terms is also high for employees.

The need to coordinate regulation and to guarantee system stability by common action on the international level is paramount and led to the establishment of a number of institutions (such as BIS) and fora (such as FSF).

A financial institution can become “too big to fail” as its collapse would endanger the whole system, with immense economic damage as a consequence. To know that a bail out has to be decided in the event of a crisis inevitably leads to moral hazard problems: Once the companies are aware that they will be saved in case of liquidity problems, they have an incentive to increase risk in order to maximize returns. Hence, there is always a trade-off between minimizing customer risks and thereby systemic risks on the one hand and moral hazard on the other hand.

The financial sector (banks and insurance companies) in Switzerland is highly developed and plays a key role in the Swiss economy. In 2007, the sum of total assets in the banking sector was about CHF 4,700 bn. Financial sector generates about 12% of value added and employs 6% of total workforce in Switzerland. Compared to other industries, the labour productivity in the banking sector is doubtless one of

1 OECD POLICY ROUNDTABLES, Competition and Regulation in Retail Banking 2006, page 209.
the highest in Switzerland. At the same time, competition in the banking sector is affected by state- and self-regulation. Compared to other countries the regulation of the banking sector in Switzerland is however rather liberal. Nevertheless, the banking sector is concentrated.

As in other sectors, cartels, market concentration and abuse of market power in the financial services sector are harmful to the economy. Therefore, financial institutions should – within the boundaries of sector regulation – be subject to standard competition legislation.

In order to avoid a conflict of objectives and to ensure coherence of competition policy, sector regulation targeting market failures should not be assessed or enforced by competition agencies, but by separate and independent agencies.

If sector regulation fails and systemic risks become apparent, it may be necessary to temporarily grant sector regulation priority over competition regulation.

In sum, the question whether competition policy should treat financial institutions and products differently should be answered by a ‘no’. Setting aside the risk of a bank run, a task the sector regulator has to cope with, financial markets are not different from markets for goods regarding their main features, and competition policy should therefore treat all markets equally.

The Swiss Cartel Commission (as antecessor of the Swiss Competition Commission [Comco]) wrote already in 1968 – well before the report of 1972 by the European Commission – about the competition relations within the banking sector², and did not consider financial markets to be distinct from other markets. In a later report in 1979³ and in the investigation on agreements between banks (led between 1986 and 1989), the financial markets were again not defined differently than other markets from a competition perspective. The subsequent practice of the Comco has not changed the view on this matter.

Also from a strictly legal point of view, the financial sector does not stand out. In Switzerland, the Swiss Cartel Act (ACart) is applicable to financial institutions as well. In addition to Article 5 and 7 ACart merger control applies. There are the only two provisions that are explicitly related to the banking sector (see also 2nd question a): Pursuant to Article 9 (3) ACart⁴ concerning the calculation of turnover and Article 10 (3) ACart⁵ about the protection of creditor’s interests in the event of a forced bank merger.

2.2 Does competition necessarily promote efficiency in financial services markets? How should “efficiency” be characterized in financial markets?

From a macroeconomic perspective, market dominance within financial markets is not desirable. Empirical surveys show that competition regulations as laid down in the ACart enhance economic benefits

³ Die Konzentration im schweizerischen Bankgewerbe; VKK 1979.
⁴ “In the case of insurance companies, turnover shall be replaced by the total amount of grossannual premiums; in the case of banks and other financial intermediaries by gross income insofar as it falls under the accounting regulations in the Banking Act of 8 November 1934.”
⁵ “If a concentration of banks within the meaning of the Federal Act on banks and savings institution of 8 November 1934 is deemed necessary by the Swiss Financial Market Supervisory Authority (FINMA) in order to protect the interests of creditors, such interests may be given priority. In such case, the FINMA shall take place of the Competition Commission (Comco), which it shall invite to submit an opinion.”
because within the boundaries set by sector regulation efficient competition is conductive to achieve macroeconomic goals\textsuperscript{6}.

From an industrial economics perspective, competition is a perfectly adequate means to promote efficiency and welfare in finance. Competition forces banks to become more cost-efficient, to be innovative, and to optimize the risk/return-relation in order to win market shares from competitors.

If agents take advantage of flaws in sector regulation to achieve competitive advantages, this is in our view not a reason to blame competition policy, but rather a reason to reform sector regulation.

In Switzerland, there is anecdotal evidence that the abolishment of several cartel-like agreements in the banking sector and in particular the agreements between members of the Swiss Banking Association (SBA) at the end of the 1980s led to a substantial decline of fees (e.g. broker’s commissions). These agreements were mainly defended on a reasoning that the unification of business practices facilitates transactions. The evolution of industry structure after the abolishment of the agreements showed that competition did not play on the prices but on quality elements.

In its report, the Cartel Commission concluded that the agreements of the SBA would slow down the adjustment of the market structure, favoring small and medium sized banks. It stated that the banking industry did not experience many bank mergers in the past. The agreements also seemed to promote disproportionately larger benefits to bigger banks as they profited much more from jointly agreed prices thanks to economies of scale and scope. The Commission did not agree with the bank’s opinion that the agreements would positively enhance the competitiveness of banks in the financial market.

Moreover, the Commission clearly stated that agreements could not lead to cost efficiencies, because the banks were not able to produce evidence for their alleged losses. Finally, the Commission recommended to dismiss various agreements. Some of those also affected the retail banking business. It criticised in particular a non-competition clause forcing third party banks as well to maintain locally established agreements. Some of the criticised agreements were of a price cartel nature as they restricted interests on saving bank books and fees for payment services, securities deposits, exchanges into foreign currencies and even tax charges. Other agreements were related to conditions on production, distribution and the use of the former "eurocheque-card", conditions of encashment, standardised general terms and conditions.

Efficiency in the financial sector is very difficult to measure and we won’t elaborate on this topic in this paper. On the level of National Accounts, services provided need to be measured by a complex methodology known as FISIM (Financial Intermediation Services Indirectly Measured). On the sectoral and firm level there are measures such as the net interest spread or stochastic frontier approaches. However, none of these methods is easy to apply to competition policy cases, therefore it would be desirable for a competition agency to have a team dealing only with questions of efficiency of competition within the financial market.

2.3 What failures of competition may have contributed to the crisis in the financial sector?

Please refer to section 2.1 for some known risks of market failures in the sector.

3. Role of competition policy in financial sector rescue and restructuring

3.1 Should competition law be set aside in the financial sector during a systemic crisis, on public interest or other grounds? If so, how should this be done?

The bankruptcy of a system relevant financial institution would by definition affect the stability of the financial system, and the real economy would heavily suffer for years. It is hardly conceivable that in a social market economy the state would not intervene in the wake of such enormous potential economical damages. Given the fact that trust disappeared in an unprecendet way in the interbank market, current times must be considered as extraordinary, calling for exceptional means.

Competition law should not at all be set aside in the financial sector during a systemic crisis. The measures taken should be assessed in the light of competition legislation. In addition, it is a general principle of law that the means taken must be proportional, that they should be non distortive and temporary if possible.

Actions taken in fall 2008 in order to support the banking system in Switzerland were in line with these principles: In Switzerland, UBS received capital during the financial crisis worth approx. 6 billion USD by issuing mandatory convertible notes (MCN) to the Swiss Confederation. The interest rate of the MCN was set at the market rate of that time, 12.5% p.a. Furthermore, the Swiss National Bank (SNB) supported stability of the financial sector by creating a special purpose vehicle (SPV). The SPV will acquire UBS assets up to a maximum amount of USD 60 billion at prices as per 30 September 2008, based either on the book value or a value determined by the SNB on the basis of independent opinions. The lower value will apply. UBS participates in the SPV with equity in the amount of 10% of the purchase price of the assets, i.e. with a maximum of USD 6 billion.

3.2 How should competition agencies apply general competition policy rules about mergers, anticompetitive conduct and state aid during a crisis? Is it practicable to apply failing firm doctrines to mergers as crisis actions? Is the consideration required for merger review of the financial sector during a crisis different from that required for merger review of other sectors? How should negative competitive impact on the market structure in the medium and long term be assessed in reviewing mergers required to sustain the financial system?

Independent of the situation in the markets, anticompetitive conduct of firms or mergers are to be assessed by competition agencies. With the revision of the Cartel Act in the mid nineties, the Swiss legislator integrated the notion of “efficient competition” into the new Act. This notion allows for enough flexibility when Comco has to assess the question of justification, also under special market situations like e.g. the actual financial crisis. Furthermore, as mentioned above, the legislator made an exception regarding the assessment of forced bank mergers by dismissing the principle of pure competition examination (Article 10 (3) ACart). The FINMA has the possibility to act in the interest of creditors. To treat the creditors’ interests preferentially may become a necessity when systemic risks become prevalent.

Since the revision of the ACart in the mid-nineties, the substantive provisions (Art. 5 ACart: unlawful agreements; Art. 7 ACart: abuse of a dominant position) as well as the provisions on merger review contain exceptions of a general nature: Art. 8 and Art. 11 ACart. These exceptions allow firms to ask the Swiss Federal Council for a revocation of the Competition Commission’s decision due to prevailing public interests. Such interests can be among others cultural, industrial, socio-political, structural interests or interests to protect labour or media markets. It is of no doubt, that systemic risks in the financial markets would also fall under these two provisions. It is then the task of the Federal Council to assess the unlawful behaviour of the concerned firms or to assess the merger under other, more political aspects.
So far, Art. 8 ACart has never been applied by the Federal Council. The Federal Council refrained from using this exception, even in a situation where the argument of system stability might have been invoked, at that time in the electricity sector. This was the case when the decision of the Competition Commission to introduce third party access in electricity was upheld in spite of the fact that a national grid operator had not been set up at the time.

Art. 11 ACart has never been applied yet although this provision would allow the Federal Council to overrule a merger decision, e.g. due to a systemic crisis that would affect the Swiss economy seriously. While the Federal Council is entitled to allow a merger between two or several firms due to such prevailing public interests, it would never be allowed to forbid a merger under these aspects.

3.3 To minimize negative competitive impact to the market structure in the medium and long term, are there effective measures as remedies (e.g. temporary behavioral commitments or certain monitoring measures)?

It is important that State aid measures are limited in time. State support should be only provided as long as it is necessary. Furthermore, measures are to be defined clearly and be limited in scope. In either case, unjustified benefits for stakeholders of financial institutions should be avoided.

See also answers 4.1 and 4.5.

3.4 What standards and safeguards or other provisions are needed to prevent distortions of competition when government funds are used for injections of equity or guarantees?

Jurisdictions have differing approaches to state aid. Compared to the European Union, which put state aid under the scrutiny of the competition chapter in the treaty establishing the European Community (EC Treaty), Switzerland does not know a state aid regulation within the scope of competition rules. State aid is to be assessed against the freedom to contract. This constitutional principle calls for an equal treatment of competitors and can normally be enforced by invoking the Federal Court as the ultimate instance. In addition, Switzerland is subject to usual WTO provisions on subsidies.

Furthermore, all financial transfers and similar forms of subsidies granted for by federal laws have to comply with the “Loi fédérale du 5 octobre 1990 sur les aides financières et les indemnités” (Subsidies Act). The measures taken in fall 2008 by the Swiss Confederation in order to stabilize the financial sector in Switzerland have been qualified as a subsidy under the Subsidies Act. In the Federal Decree on Measures for Strengthening the Swiss Financial System, the Swiss government considered principles of subsidiary, public interest, effectiveness, efficiency and limitation in time. It was stated that the decision to recapitalize UBS by granting a subordinated loan (a call by UBS transforms it in share capital) conforms to the conditions laid down in the Subsidies Act7.

4. Real economy: Challenges for competition policy in periods of retrenchments

4.1 What should be the position of competition agencies towards subsidies to failing firms or sectors? How should they respond to efforts to protect national champions and obstruct acquisitions by foreign investors?

Reasons for state aid must be well defined in terms of content, target market and duration. Generally, any firm offering the same products or services must be eligible (e.g. for a guarantee scheme), otherwise competition is distorted.

7 Botschaft zu einem Massnahmenpaket zur Stärkung des schweizerischen Finanzsystems, page 46.
The situation is different, when a planned measure will not only affect a single market player. Dropping out of the market is a normal process for companies, which are unable to allocate their resources in response to market conditions. State interference like state aid distorts the market process and leads to undesired effects on market structure. Therefore, government interference in the wake of a company failure should remain an exception and be considered the ultimate measure, only admissible in extraordinary circumstances (a challenging case arises when the preservation of a competition driven market structure which would disappear or pass over to an oligopoly or even to a monopoly without state intervention is at stake). It would not be justified to keep artificially alive a company in a sector characterised by long term overcapacity.

If only a single market player is offered government support, the state aid must be based on public interests that outweigh the interest of establishing effective competition (which itself is part of the public interest). State aid as a rescue measure should be temporary, and tied to the condition that the benefiting company sticks to a restructuring or a liquidation plan. When it comes to restructuring, the firm must provide an adequate and substantive inhouse-effort to overcome the difficulties.

Given the scope of cartel legislation in Switzerland, it is not possible for the competition authority to take formal decisions stating that planned state aid measures are in line with competition principles. This applies also to measures that aim to protect so-called “national champions”. However, the competition commission is legally mandated to submit proposals to other authorities in order to enhance efficient competition. This occurs when legal provisions in the realm of commercial law are established (Art. 45 ACart). Furthermore, the Competition Commission and its Secretary have to be invited by the Federal Administration to comment on drafts on commercial legislation (e.g. sector regulation) which could influence competition (Art. 46 ACart).

Moreover, art. 2 ACart clearly states that public institutions fall as well under the scope of the Cartel Act. For example, the Swiss National Bank as a public institutions must act within the scope of the ACart (but consider the reservation in Art. 3 (1) regarding special sector regulations).

4.2 How should competition rules apply to acquisitions of failing firms or firms in distress, in current financial market conditions? How should negative competitive impact on the market structure in the medium and long term be assessed in reviewing mergers or state aid?

Competition rules do also apply in periods of economic contractions. There are no reasons why this should not be the case. If this assertion should turn put to be wrong, as already mentioned above, there are two provisions which allow the Federal Council to overrule Comco’s decisions due to predominant public interest.

It was already mentioned as well that there is a provision within the rules related to mergers pursuant to which the Financial Market Surveillance Authority (FINMA) may take Comco’s place. This is the case when the merger is necessary for the protection of creditors. FINMA is then obliged to invite the Comco for a comment on the competition situation. Additionally, the concerned parties may - under certain conditions - also request a prior authorization (Art. 32 para. 2 ACart).

The failing firm doctrine had been applied several times by Comco. It used the same criteria as the European Commission. These are:

- without the merger, the failing firm would in a short time disappear from the market;
- the market share of the failing firm would in any case be absorbed by the take-over firm;
• there is no appropriate solution that would harm competition less than the planned merger.

In times of economic crisis, there may be over-capacities in the market and firms could intend to coordinate their behaviour by agreeing on reductions of output. Such agreements shouldn’t in general be allowed by competition authorities.

4.3 Will tightening financial markets create barriers to entry and expansion in the real economy? If so, how should competition enforcement respond?

It is very probable that – on the global scale - the financial market crisis has led to tightened access to credit. Hence, barriers to entry and expansion may well have developed in capital-intensive sectors of the economy. As long as this leads only to retreat of inefficient market players, there is no economic harm in the long term. However, if liquidity problems tend to become a wider-spread issue in the economy, countermeasures by governments and central banks might become necessary.

Currently, within Switzerland, lack of liquidity is only a concern in the interbank market. At the moment of writing, there is no specific task for competition enforcement. Should a need for action arise, competition agencies should make use of their advocacy role in order to favour the adoption of non-distortive measures. The special provisions in Art. 99 and 100 (3) of the Constitution need to be considered.

4.4 How should competition policy respond to proposals for modern versions of “depression” or “rationalization cartels” and similar schemes? What lessons can be drawn from previous crisis-driven policies to reduce competition, such as the self-regulation that was encouraged during the depression of the 1930s?

In Switzerland, the Competition Commission assesses agreements between undertakings purely based on their effects on competition and efficiency. Therefore, rationalization cartels would be deemed unlawful if they infringe cartel law, e.g. by fixing prices or quantities. However, the Swiss Federal Council can exceptionally approve cartels for a limited period if there is a prevailing public interest and if such approval would be necessary, appropriate and proportionate. So far, the Swiss Federal Council has never applied the right to exceptionally approve cartels and has always rejected proposals to do so.

It can be assumed that rationalization cartels infringing cartel law are only rarely an appropriate instrument. It is questionable whether such an agreement can stand the test and qualify as proportionate. Rationalization of a sector can usually be achieved without infringing cartel law, and even if there is a need for competing companies to cooperate under exceptional circumstances, such cooperation does not need to include agreements on prices and quantities. If there is a need to restructure a whole sector, it is probably better for the economy in the long run and preferable if (non-dominant) healthy firms take over struggling firms than limiting competition in a whole sector.

4.5 Is it necessary to consider the risk of harming long-term economic development by revitalizing failing firms via protective measures by the government and consequently putting other healthier firms at a disadvantage in their terms for competition?

The way the question is raised suggests the answer. When governments put healthy firms at a disadvantage compared to struggling firms, inefficient behavior is rewarded and the consequences for long-term economic development are likely to be detrimental. Capital injections by the state and protective measures for selected companies bear the risk of creating moral hazard issues beyond the sector concerned.
5. Going forward

5.1 What have competition agencies learned from merger decisions in financial services sectors? How have they dealt with interactions between, and evolution of, financial markets?

So far, the Swiss Competition Authority was not yet involved in many merger procedures that were related to the on-going financial crisis. Only foreign banks with subsidiaries in Switzerland have been involved into merger procedures. The mergers did not heavily affect competition in Switzerland, as the markets concerned were the markets for financial services to private clients and to medium and large companies as well as to institutional investors. Those markets are not concentrated in Switzerland.

Moreover, the transactions that were so far conducted in order to stabilize the banking system did not fall under the merger rules of the ACart, because the thresholds were not met.

The last financial crisis in Switzerland took place in the early nineties. At that moment, the Cartel Act did not entitle an independent body to examine planned mergers. Therefore, the former Cartel Commission was not obliged to analyse the mergers that took place. As a result of this turmoil in the Swiss real estate sector, two Cantonal Banks disappeared from the market. It was in 1998, when the most important merger in the Swiss banking history took place, namely the merger between the Union Bank of Switzerland (UBS) and the Swiss Banking Cooperation (SBC) becoming UBS AG. The merger did not fall under art. 10 (3) ACart as there was no need to assess the merger with respect to the protection of the interests of creditors. Nor was there a demand for a prior authorization.

Since the revision of the Cartel Act in 1995, the provision in Art. 10 (3) ACart has not been applied yet. Item for the failing company doctrine: no merger within the financial sector has ever been reviewed under this premise.

5.2 How can competition policy seek to improve competitive conditions in the financial sector, such as by reducing switching costs or improving the availability of credit data?

In Switzerland, the system of universal banks currently prevails. For example, in terms of regulation, there is no differential treatment of investment banks or savings banks. We therefore think that government should not regulate financial markets in favour of specific banks or a specific parts of the banking industry. Under precautionary provisions set in a non-discriminating way by sector regulation, market access should be free for everyone who wishes to offer financial services. This requires that entry barriers are not too high and that competition rules are handled by the competition authority effectively. Industry structure changed considerably in the past to decades (since the abolishment of the agreements of the SBA). The number of large banks shrank from five to two. At the opposite end of the scale, the Raiffeisen Group has increased its number of branches and penetrated the local markets in urban areas in the last few years.

Regarding the availability of credit data, the legislator provided within the Swiss Consumer Loan Act, that the banking industry is required to create a common institution (information center for consumer credit). The aim of the body is to collect data on credit granted by the financial institutions. Banks or other financial institutions that would like to offer credits (consumer credits, leasing, overdraft facilities) are obliged to report these data to the common institution (these data do not contain information on market parameters like prices or other conditions). At the same time, they also have to check the credit standing of customers in search of a credit.

Every bank and financial institution that wishes to offer consumer credits has access to this database. The competition authority recently assessed this type of data collection and did not find a sign either of an illegal exchange of market information or of an abuse of a dominant position, such as imposing inappropriate prices or conditions to banks asking for access to the database.
5.3 **Should competition authorities extend the conception of consumer welfare to include macroeconomic benefits from ensuring system stability?**

A separation of tasks between the regulatory authorities is most useful for maximizing welfare and eliminating conflicts of objectives. Competition authorities should focus on the analysis of effects on efficient competition. An expansion of the agencies’ analysis to other issues is likely to weaken competition policy.

Therefore, analyses beyond competition policy, such as ensuring system stability, should be carried out by other specialized authorities, such as central banks or financial sector regulators.

5.4 **How does state ownership affect competition? Should bringing a number of individual firms under public control be treated as a notifiable “merger operation”?**

A bank fully owned by the state could possibly get a competitive advantage in getting cheaper access to capital as the default risk of a state-owned bank is probably lower than for the standard privately owned bank. Furthermore, a state-owned bank could come under pressure to give loans to companies according to political priorities instead of business criteria. Competition in other markets could be distorted as well.

Therefore, state ownership should be avoided; to take over financial institutions should only be considered if necessary and appropriate to reestablish functioning credit markets.

For historical reasons, most cantons have a bank owned by the state. Cantonal banks still benefit from exceptional provisions (state guarantee and a reduction on equity capital). The state guarantee in itself does not necessarily qualify as a competition distortion, but it could do so in relation with the canton as owner\(^8\). The rebate on equity capital is in the stated opinion of the competition authorities not justified\(^9\).

The scope of the ACart comprises all customers and suppliers of goods or services regardless of their legal or organisational form. Whether Art.2 ACart applies is to be assessed according to the modality and dimension of a possible state influence on an enterprise. Depending on the outcome, merger control (article 10 ACart) and its Ordinance on Merger Control will be applied. Nevertheless, competition provisions may rank second when creditors’ interest are treated preferentially and Art. 3 (1) needs to be considered.

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5.5 On the relationship between financial sector regulators and competition authorities:

How does the role of competition agencies interact with the role and remit of authorities and regulators responsible for financial services, securities and commodities exchanges, monetary policy, financial stability and accounting standards? What should be the respective responsibilities and scope of coordination between competition agencies and these regulators? Should competition agencies develop in-house expertise about financial markets?

What are the legal and practical impediments to competition agencies and financial sector regulators sharing information and market analysis and working together to formulate policy initiatives and interventions? How best can competition agencies engage in coordinated competition advocacy?

As the institutions for overseeing and regulating financial markets are improved, how can the policy goals of market competition and financial system security be best coordinated?

Except the provisions of art. 10 (3), art. 45, and art. 46 ACart, there is no specific provision in the ACart which deals specially with the relationship between the competition authority and other authorities and regulators in the financial sector.

Beside the ACart, only two other Federal Decrees relate within the financial markets to a cooperation with the competition authority. On one hand, the Swiss Financial Market Supervisory Authority (FINMA; formerly the Federal Banking Commission) has to assess whether the self-regulation of (stock) exchanges guarantees transparency and equal treatment for investors, in addition to the check of the operability of stock markets. It therefore may consult the competition authority that will give its opinion. The Competition commission in particular has to express its view whether self-regulation is neutral regarding competition and will not promote agreements limiting competition (art. 13 of the Swiss Federal Ordinance on Stock Exchanges and Securities Trading).

On the other hand and contrary to the principle of open access, the operator of a systemically important payment and securities settlement system may restrict access provided such an act achieves a reduction in risk or an increase in efficiency, and that such an effect cannot be brought about by other means. Before a restriction in access is asserted for reasons of efficiency, the SNB shall in its assessment consult the Federal Competition Commission (Art. 33 par. 3 of the implementing Ordinance on the Federal Act on the Swiss National Bank).

So far, the Competition authority has never been formally contacted on the basis of these provisions, but it informally meets these institutions as often as necessary to exchange information and knowledge not only on the topics mentioned in the provisions but also on other topics. Nevertheless, these institutions are subject to provisions that prohibit the exchange of secret business information (banking secrecy and statistics secrecy). Therefore, it is not possible for the competition authority to collect existing data from these institutions.

Due to lack of resources, the Competition Authority is unable to develop in-house expertise about financial markets in general, although such an expertise would be highly valuable. This would enable the Competition Commission to assess the financial markets not only in the case of a formal procedure. Examples like the Financial Sector Monitor Group of the Dutch competition authority NMAs show that in-house expertise would facilitate work, especially when it comes to complete merger procedures within defined time periods.
TURKEY

Financial Sector Conditions and Competition Policy

Financial markets differ from other markets in two aspects. First, the most distinctive feature of financial markets is the existence of asymmetrical information problem. Another important feature of financial markets is the fact that when financial institutions face hardship, actors in the other segments of the economy are directly affected by this. These two features require that financial markets be subject to special regulations compared to the other markets.

The concept of stability in financial markets, especially in banking sector, has always been kept in the forefront due to the fact that these markets are characterized to affect other markets directly. Competition in banking sector lies at the center of the policy discussions concerning financial stability. Even though the existence of competition is important for an efficient banking system too, there are also views that excessive competition lead to instability and thus restraints on competition are necessary for the stability of banking system.

The relevant literature (theoretical and empirical studies) on the relationship between the stability of banking sector and competition do not seem to have reached a clear conclusion in this respect. The fact that the net effect of the risk resulting from bank consolidations change depending on the case and many types of competition do not threaten financial stability, indicate that there is no clear proven tradeoff between competition and stability. There are many studies in the literature defending both of the arguments.

Studies showing that there is a tradeoff between competition and stability state that competition results in banks taking various risks to maintain their profitability when faced with increased competition, eliminating the need to work cautiously, which in turn increase the bankruptcy risks of banks. Increased credit risk in debt portfolio and lack of capital can be given as examples of such risks.

On the other hand, there are also many studies to the effect that increased competition in banking sector affects financial stability positively. According to these studies, increase of competition will result in decrease of interest rates in credit markets and thus in decrease of bankruptcy risks and costs of debtors. This will at the same time increase the recycling of the issued loans and therefore bankruptcy risks of the banks will also decrease.

Foremost among the important issues to be taken into consideration when evaluating the relationship between the stability of the financial system and competition is the existence of an institutional framework. In a banking system where free market rules are in effect and which is supported by the required

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institutional framework, competition is not harmful for stability, *per se*. Policies for a competitive financial system such as removing the limitations on activities and the barriers of entry and allowing the entry of foreign banks may also ensure stability. However, institutional framework is the indispensable condition for achieving the maximum benefit expected from competition. To explain, though uncontrolled competition may cause fragility in a banking sector with a weak institutional framework, it would be more appropriate, in terms of economic growth, to focus on developing this institutional framework instead of limiting competition, at least in the long-run.

Even though it is important to ensure stability in financial markets, this should not be the sole purpose of policy-makers. For economic growth, it is also important to establish a deep and efficient financial markets structure.

In light of all of these arguments, it is thought that the consideration of the following points would be beneficial:

- Similar to other industries, the level of competition will affect the efficiency of the services, the quality of the products and the degree of innovation in financial markets, as well.

- Another important factor to take into account besides the stability in financial sectors is the effects of the level of competition in these markets on the concentration and economic growth in other markets.

- The first thing to do in financial markets is to create efficient financial markets which could support real markets and achieve the best allocation of the savings of the society, and to establish a regulatory structure which would ensure the above.

After these explanations on competition and stability in financial markets, it is important to discuss under this topic the issue of competition and efficiency in financial markets. For further discussion on this issue please see paragraph from 13 to 16 (pages from 5 to 7) of the country contribution prepared for Roundtable II by Turkey.

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1. Introduction

Turkey experienced a significant economic crisis starting and in late 2000 and deepening in early 2001. The economic crisis broke out mainly in banking sector and influenced other parts of economy rapidly. As the economic crisis originated from financial markets as in the case of recent economic crisis, the measures taken with respect to financial markets played a major role in tackling the crisis. Thus considering the nature of recent global economic crisis, it is possible to argue that Turkey’s experience in early 2000s may present certain lessons to be drawn.

2. Banking sector restructuring program (2001)

Following the November 2000 and February 2001 crises which had negative impacts both on the economy and the banking system, an extensive streamlining plan, the Banking Sector Restructuring Program was started by the Banking Regulation and Supervision Agency (BRSA) which was founded in 1999. The restructuring program envisaged mergers, acquisitions and liquidations of insolvent banks before all else. Thus, mergers where the total asset share of merging banks was below 20 per cent of total assets of the banking sector were exempted from the merger review under the Act on the Protection of Competition No: 4054 (Turkish Competition Law-TCL). Besides, bank mergers were supported by certain tax subsidies. In this context, the program was based on the following main pillars: (1) Restructuring of state banks, (2) Prompt resolution of Savings Deposit Insurance Fund (SDIF) banks, (3) Strengthening of private banks, and (4) Strengthening the regulatory and supervisory framework.

2.1 Restructuring of State Banks

Despite the fact that both private and state banks had accumulated risks on the road to the crisis, the nature of the problem was different. On the asset side, the increasing size of “duty loss” accumulation of state banks and the need to finance it by short-term domestic bank liabilities were the source of the problem. On the liability side, the ratio of lira to foreign exchange liabilities shows one major difference between the two groups. The ratio was much lower and moreover was decreasing for private banks. While state banks were more open to interest rate risk, private ones were more prone to exchange rate risk. This is why the November 2000 crisis had hit state banks the hardest and the effect of the currency collapse in February 2001 was just the reverse (Özatay and Sak, 2001).
A resolution plan entered into force with regard to the restructuring program of Ziraat and Halk Bank (Emlakbank was transferred to Ziraat Bank in July 2001). The resolution strategy for the duty loss problem (losses incurred by state banks due to subsidized lending) included two components: Preventing new duty losses, and managing the stock of outstanding claims. To prevent new duty losses, laws and cabinet decisions that caused service losses were terminated. To manage the stock of duty losses, the overall total resources transferred to state banks with the aim of tying duty loss receivables from the Treasury (US $ 19 billions) to securities and providing capital support amounted to US $ 2,9 billions. In addition to the removal of the duty loss problem and capital strengthening, the short-term liabilities of state banks were eliminated and deposit rates of these banks were determined in line with market rates.

On the other hand, steps have been taken within the framework of operational restructuring. Organizational, technological, product, human resources, loan issues, fiscal control, planning, risk management and service structures of banks have been restructured in compliance with the requirements of modern banking and international competition.

2.2 Resolution of SDIF Banks

22 banks were taken over by the SDIF between 1997-2005. After the BRSA started to operate on August 31, 2000 (in addition to the existing eight banks), the administration of 14 banks was assumed by the SDIF according to the resolutions of the BRSA. Merger method was used for 13 of 22 banks taken over by the SDIF, while sales method was used for 5 banks and liquidation method was used for 3 banks, and 1 bank was structured as a transition bank to execute asset management function. It is observed that the total balance-sheet size of the said 22 banks by the year-end before the analysis strategy is executed constitutes about 15% of the total assets of the sector. The number of personnel of the said banks is about 21% of the total number of personnel in the sector.

With a view to accelerating the resolution process, SDIF banks have been subjected to a comprehensive financial and operational restructuring process. Accordingly, the short-term liabilities of SDIF Banks have been liquidated, and a portion of deposits and F/X liabilities has been transferred to the other banks. In addition, some of problem receivables assumed by the SDIF have been sold to third parties, thus efficiency in follow-up and collection activities has been ensured.

2.3 Strengthening the Private Banking System

Strengthening private banks whose financial structures and profitability performances got worse due to the crises experienced composed an important part of the Banking Sector Restructuring Program. Within the scope of the program, the focus was on private banks, the policy priority was to strengthen capital structures of private banks with their own resources and limit market risks. In this context, the Bank Capital Strengthening Program was designed and implemented. With the implementation of the “Programme for Strengthening the Capital Base of Private Banks”, commitment letters from banks with capital inadequacy problem were taken and the practice was carefully monitored. Additionally, a voluntary debt-restructuring program between banks and credit customers, known as the Istanbul Approach, was introduced to resolve non-performing loan problems of private banks. As a result, balance sheets of private banks have become more transparent and risk-sensitive.

2.4 Strengthening the regulatory and supervisory framework

Concurrently with the financial and operational restructuring of the banking sector, significant progress has been made in legal and institutional regulations, which would strengthen the surveillance and supervisory framework, ensure competitiveness and efficiency, and improve confidence in the sector.
Within this context, regulations were issued to prevent risk concentration in loans, limit participation of banks in non-bank financial institutions, and ensure preparation and disclosure of balance sheets of banks in compliance with international accounting standards. Among many other structural reforms, the banking reform intended to upgrade and modernize the current rules and in general covered the following banking-related areas: capital adequacy, foreign exchange exposure, internal control and risk management, deposit guarantee schemes, accounting standards for financial disclosure purposes, prudential reporting, and loan-loss provisions.

3. Competition and the crisis

The 2001 economic crisis is the only period where economic crises experienced in Turkey and competition law practices intersected. Within this framework, clues as to economic crises in Turkey and competition law practices can be found in the assessment to be made under the 2001 crisis.

In the post-2001 crisis period, with the exit from the system of the banks whose financial nature deteriorated, mergers/acquisitions among banks, changes experienced in market shares, and serious decrease experienced in the number of banks, concentrations in the banking sector increased. With the developments experienced on the way to economic integration with the European Union, financial groups’ showing interest in the banking sector, which had a foreign origin also increased the mobility. There exist studies that with the restructurization experienced in the sector, elimination of unlimited deposit guarantee, strengthening of legal regulations, avoiding from excessive risk-taking behaviour, and productivity increase in the sector enhanced efficiency in the banking sector despite the concentration in question.

3.1 Bank Concentration, Competition, Efficiency, and Business Stealing Effect

As asserted by Vickers (1995), competition could enhance efficiency: i. by sharpening incentives to avoid sloth and slack; ii. by causing efficient organizations to succeed at the expense of inefficient ones; iii. by promoting innovation to create differences as compared with competitors. However, one should question, as asserted by Vickers (1995): “does more competition, in the sense of more firms, improve productive efficiency?” The answer depends on whether organizational, financial, and technological structures of firms in markets are symmetric or asymmetric. Because the negative externality that an additional entrant imposes on existing firms by taking (stealing) business from them will outweigh the positive externality to consumers in terms of lower price. Vickers concludes that if all firms are assumed to be symmetric, competition cannot enhance productive efficiency, by analyzing various possible differences of unit cost levels between incumbent and entrant firms. If the entrant has a higher cost than what the incumbents have, the net externality of entrance is zero because entrants will shut down. On the other hand, if the entrant and one of the existing firms have a lower cost than what the other incumbents have, the net externality of entrance is positive because at least one of the incumbent firms will end up producing. Various things could happen between these extreme cases.

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Figure 1 shows developments in the number and efficiency scores of commercial banks during 1990s. Especially after the crisis of 1994, there was a rapid increase in the number of commercial banks from 53 in 1989 to 62 in 1999. Mercan et al. (2003) utilize linear programming-based technique (Data Envelopment Analysis, DEA) and fundamental financial ratios selected according to the CAMEL approach to assess the relative performance of commercial banks in Turkey in the 1989-1999 period. The study concludes that the overall efficiency measure for the sector in the 1989-1999 period had an increasing trend until the 1994 crisis with a reversal from then on. According to the findings of the study, the evaluation of efficiency in the Turkish banking sector was very much dependent on the mode of ownership, and size. The differences in financial performance between sub-groups (large, medium and small-scale by size) of private banks could be attributed to the dissimilarity of their funding decisions.

After the liberalization of capital movements in 1989, medium and small-size banks with fewer branches than large-scale banks gained access to foreign funds between 1989 and 1994. Nevertheless, after 1994 crisis, foreign creditors showed a reluctance to extend credit to Turkish banks. Medium and small-size, mostly de novo banks started to compete (or steal business from) in deposit markets with large-scale banks.

Despite the general belief that de novo banks operate more efficiently than incumbent banks, newcomers could not outperform incumbent banks in the long run in the Turkish case. Supporting this opinion, Işık and Hassan (2002) assert that consistently falling efficiencies over time resulted from increases in the cost of funding and growth of banks in 1990s. On the other hand, in a recent study, Işık (2008), employing a non-parametric frontier method to investigate the technical X-efficiency and productivity growth of de novo banks vis-à-vis established banks in Turkey during 1981 to 1996, shows that although de novo banks could outperform established banks in the short run, because of the quite limited economies of scale opportunities from expanding production scales in the Turkish banking market, diseconomies of scale issues begin to emerge as banks approach the age of ten. On the other hand Alper and Öniş (2003) state that the entry of new banks in itself should not be interpreted as a negative development. The granting decisions as to new bank licenses were influenced by

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4 On the other hand Alper and Öniş (2003) state that the entry of new banks in itself should not be interpreted as a negative development. The granting decisions as to new bank licenses were influenced by
separately the effects of foreign and domestic entries and suggests that banking authorities, especially in emerging markets like Turkey, may use foreign entries to boost the efficiency performance of their banks, since foreign entries are both more efficient and register faster productivity growth than domestic entries. In line with this suggestion, the sector share of foreign banks in total assets, deposits and loans increased respectively from 3%, 2%, and 4% in 2002 to 16%, 14%, and 19% in 2007 after the restructuring process.

3.2 Competition Law Enforcement

As mentioned above, mergers and acquisitions in the banking sector where market share of the parties, calculated in terms of total assets, is below 20% are excluded from the jurisdiction of the Turkish Competition Authority (TCA). The reason for such an exception is basically related to the urgency of measures to be taken and the time required for merger review under the TCL. In this regard the necessity of intervening in systemic problems in the banking sector in short time and of concluding the transaction as soon as possible in the crisis period prepares the ground for the regulations in this respect.

As stated by both international and official reports, this exception limits enforcement of merger control rules in the banking sector. One of the targets of the Banking Restructuring Program was to strengthen the regulatory framework to enhance competition and efficiency in the banking industry. But the regulation referred to has been preserved even after the banking sector was made to reach a healthy structure, in equal wording, even after the emergency passed. In this respect, the analysis responsibility of whether any merger proposal would restrict competition has been supposed to belong to the TCA. This conflicting regulation which could be reasonable and justified to an extent in time of crises, could in normal times hinder the TCA’s efforts to promote competition. And furthermore, this situation has been the subject of miscellaneous criticisms. For example, in the 2000 and 2005 review reports of the OECD as to Competition Law and Policy in Turkey, it is recommended that the consideration of competition policy in concentrations in the banking sector be re-established.

However, despite the existence of such an exception from merger review, the TCA enforced the competition rules actively. The Competition Board examined and finalized all complaints and similar applications regarding the practices of undertakings in banking services. While examining these cases, the TCA made an analysis of alleged infringement on the basis of competition rules without any other concern. Thus TCA opened further investigation where it saw a possibility of serious infringement and/or sent formal opinion to the relevant undertaking to restore competition where it is distorted. Thus the TCA kept its enforcement activities in financial markets despite the existence of economic crisis.

political priorities and this generated perverse outcomes not only on the banking sector but also the economy at large.

5 According to the BRSA figures, as of March 2008, the share of public capital in the Turkish banking sector is 25.2% and the share of private capital is 34.8%. On the other hand, according to the calculations made regarding banks stock transfer process over the same period and considering new foreign capital investments made in different rates, the share of global capital in the Turkish banking system is 26%. When stocks held by foreign residents (14% stock market shares) are added to this ratio, the total foreign capital share becomes 40%.


7 SPO, 2005.
4. Lessons learnt from the Turkish financial crises and restructuring process

Costly 2000-01 financial crises that occurred in Turkey provide striking lessons in terms of (in)efficiency and (in)stability (dis)advantages. Due to the restructuring process initiated to restore the health of the Turkish banking system, the Turkish economy has suffered less from the global financial crisis, as compared with the financial system of many developing countries, even the developed world. The first major lesson learnt from the 2000-01 crises is the vital importance of prudent regulations and effective supervision to stabilize markets and support competition. The second lesson is about the measurement of competition and efficiency in (financial) markets. Structural measurements such as the HHI and bank concentration ratios do not always provide clear guidance to analyze and evaluate (anti)competitive developments in the relevant geographical and product markets. Finally, state aids granted to rescue and restructure banks in difficulty and to reinvigorate confidence can themselves be a source of systemic risks by triggering moral hazard and adverse selection, and distort the level playing field by discriminating among financial institutions.

4.1 State Aid: Full Deposit Insurance and Moral Hazard

Although it has been her responsibility after having committed to comply with the EU state aid control regulations which envisage the supervision of state aid regulations of the Member States in terms of whether the proposed regulations would potentially restrict competition, Turkey does not have any such legislation. Moreover, there has been no general framework legislation like the EU equivalent: State Aid for Rescuing and Restructuring Firms in Difficulty. Despite the lack of the evolutionary mechanism for proposed and implemented state aid measures, it could be assumed that the most frequently implemented subsidies have been capital injections, tax incentives and deposit guarantees.

The 1994 crisis forces authorities to take dramatic measures to save the banking system from collapse. The most controversial one among others was the full deposit insurance scheme introduced to curb bank run. However, the fear of new financial crises prevented authorities from abandoning this supposedly temporary measure. The full deposit insurance which had caused moral hazard remained in force until the financial crises of the 2000-01. The full deposit insurance scheme led banks to offer higher interest rates to depositors and tolerated the development of an unhealthy banking industry. Finally, full deposit insurance was converted into full guarantee for all liabilities of banks to prevent bank runs and deposit shifts from private banks to public banks in the crises of the 2000-01.

Government guarantee over savings deposits hindered the improvement of competition in the banking sector, and encouraged banks’ tendencies towards adverse selections. The credit rationing in the Turkish banking sector broadly relied on sister-company lending as one can argue that many large corporations - benefiting from deregulation - bought or established new banks to seize cheap credit opportunities.

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8 This scheme has been controversial because as generally accepted in the banking literature, it causes agency problems in the form of moral hazard which induces banks to take greater risks, since they know that a state-financed safety net to catch them is available if they fall. The deposit insurance scheme reduces incentives of depositors to monitor banks closely by insulating them from defaults. Accordingly, a full insurance scheme encourages depositors and in turn banks to accept higher interest rates even if these real returns are associated with higher default risk.

9 Although there is a widespread belief that asserts banks mainly financed their sister companies or affiliations, this belief could not be quantified because of the insufficient statistics. The ratio of “the indirect credit/equity capital” has been reduced from 75% to 55% by amendments to the banking legislation in 2003. That means banks can supply credit to their sister companies or affiliations as much as 55% of their equity capital after the amendments. On the other hand, the State Supervisory Council asserts in its report (2003/1) that contrary to these legal limitations, some banks rationed over 80% of their total
However, the lack of fair competition catalyzing bad governance and moral hazard problems in the banking sector, which had been tolerated until the end of 1990s, were the major impediments for banking institutionalization and subsequently imposed a huge burden on Turkey, in terms of less output and higher public debt burden arising from the rehabilitation of the sector (CBRT, 2002). Finally, the coverage of deposit insurance was limited to enhance effective competition in 2004.

5. 2008 global crisis and Turkey

The difference of the 2008 crisis from the other crises is that this crisis is exactly a global crisis and affects all countries in the world. It is emphasized that in the origin of the global crisis which first exploded in the USA in September 2007 and later spread to the whole world in waves, there lies the largest real estate and credit balloon of the history.

Unlike the crisis in 2001, in the existing situation, a problem that would cause crisis is indeed not in question in balance sheets of banks in Turkey. Thanks to the legal regulations in the banking sector after the 2001 crisis, the banking sector presents a sounder structure as compared with what it was in the past. This situation forms the most important difference that distinguishes Turkey from the other countries. According to the BRSA data, while the legal equity rate as of November 2008 increased, a decrease has happened in the risk-weighted items. In this period, capital capability standard ratio rose to the level of 17.53%. Furthermore, together with a decrease in syndication and securitization credits in this period, resources secured from abroad entered into a process of decrease. In this development, liquidity problems experienced by financial agencies themselves that are in a plight due to the global crisis have been influential.

According to the findings of the Banking Sector Manager Segment Expectation Survey of the BRSA, in respect of January-March 2009, bank managers do not expect an increase in credits originating from abroad and in the foreigner share in the banking sector, consider that the deterioration in macroeconomic conditions would adversely affect the sector (87%), highlight the foreign capital entry (45%) and macroeconomic developments (39%) among the factors that would develop confidence in the banking sector, point out credit risks as the most important source of risk (87%), and believe that these risks would progressively increase (74%). Besides all these, the narrowing of demand in export markets of Turkey may adversely affect export, the manufacturing sector, employment, and eventually internal consumption by the narrowing of consumption. Consequently, due to the global crisis, there would be a narrowing in fund transfer that would arrive to Turkey from abroad and that is needed by Turkey, and this would put one into tightness in liquidity in the financial system.

For purposes of diminishing the adverse effects of the global crisis on the Turkish economy, a joint stability program is being studied with the IMF. On the other hand, with a view to generating a solution to the liquidity problem experienced in markets, the Central Bank resorted to interest reduction and commenced to inject liquidity into the market through monetary policy instruments. The Central Bank primarily resorted to reductions in its own policy interests beyond expectations. Besides this, against the likelihood that the problems experienced in the recent periods adversely affect the Turkish banking system, the Bank pursued an active policy, it took measures particularly directed at efficient functioning of the foreign exchange market and supporting the foreign exchange liquidity. Within this framework, it commenced the transactions of the interbank Foreign Exchange and Banknotes Markets Foreign Exchange Deposit market operated through its agency. It increased the transaction limit of banks in this market. The maturities of foreign exchange deposits that can be provided by the Central Bank to banks have been extended and their interests have been lowered. In addition to these measures, an additional foreign credits to companies of the controlling shareholders by using fraudulent transactions such as “fiduciary loans” and “back-to-back credit rationing between collusive banks”.

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exchange liquidity was provided for the banking system by resorting to a reduction in the foreign currency required reserve ratio.

6. Concluding remarks

The literature of industrial economics shows that as is the case in the other sectors, competition in the banking sector is an essential mechanism to improve welfare (Frexias and Rochet, 1998:51). As such, the Turkish reform strategy was to promote financial market development through deregulation and inducing competition and by easing entry into the banking sector since 1980s. Opening up the banking system to foreign competition was seen as an important element of enhancing competition (Atiyas and Ersel, 1996). However, reformers have paid less attention to enact and enforce required rules and institutions other than entry facilitations to promote and protect competition. The required institutional framework of a country to promote competition and efficiency and to protect stability and solvency in the financial system should comprise good quality legal infrastructure, and evolutionary capabilities and accountabilities of public agencies responsible for providing a level playing field in financial markets.

In Turkey, the culture of competition law and policy is quite new as compared with many countries. On the other hand, the culture of crisis (!) is quite established. In the post-1980 period, Turkey experienced a large number of economic crises some of which stemmed from external shocks and some from internal imbalances. And the only crisis experienced since the period when the TCL was commenced to be applied actively has been the 2001 banking crisis. This crisis which stemmed from the fragileness in the banking sector led to a foreign exchange crisis at the same time. The first area where competition law and economic crisis met has been the banking sector. In this period, with a justification for urgent intervention, concentrations in the banking sector have been excluded from the scope of the TCL. But the exception article in question has also been preserved in the period after the crisis. The policy preference referred to is remarkable also in terms of showing the attitude of policy-makers and economy bureaucracy in Turkey in believing competition and virtues of competition policy.

It is considered that competition policy should be absolutely regarded in processes of forming micro and macro policy alternatives to be applied in combating a crisis. For example, representing competition authorities as well in various structures where macro economic policies are formed and coordinated, in other words, making these processes gain a competitive policy viewpoint would aid economies to reach stable growth targets in the medium and long term. Furthermore, the suggestion in question becomes more essential in countries like Turkey where competition culture has not established itself particularly in the management of economy.

Just as it is wrong that people and organizations responsible for the management of macro-economic policies act without regarding competition policies in practices performed by them in the financial crisis medium, competition authorities’ not taking place in financial crises actively and not possessing sufficient preparation as to these matters are likewise one of the basic deficiencies. In this regard, despite the economic development-focused goal of competition law and policy, the deficiency of not regarding competition policy in general economic regulations demonstrates itself in the processes of experiencing and preventing crises as well.

Moreover, the request to apply competition laws in a more flexible manner, which is among the precautions that first occurs to the mind in periods of crisis also carries to serious dimensions the peril that sectors, independently of financial markets and crises, continuously raise this situation with the pretext of entering into a crisis. And the extreme examples of this situation are straightforwardly exempting competition laws from being applied to certain transactions and sectors. The regulation made in the Banking Act in the 2001 crisis in Turkey, and approaches that push the supervision of competition to a
secondary position in merger control in the other countries in the 2008 global crisis are concrete and
dangerous examples of this situation.

In this regard, it should also be taken into consideration that such kind of regulations made with a
justification for ensuring economic stability in the short run would complicate in the long run reaching
benefits expected from competition policy and may actually harm economic growth.
REFERENCES


Turkce: Sınır Dolu Yatırımların İhtiyaçları

1. The Effect of the Global Financial Crisis on Turkish Economy in General

Financial crisis, which started in mid-2007 in the USA with failing mortgage payments, grew larger in size by spreading from one institution to another due to the horizontal nature of the financial sector, and have reached a global dimension through the recent bank failures and the consolidation of the financial institutions in the United States as well as Europe. Currently, the crisis has effects on the global scale, not only for financial markets, but for the whole economies.

The Turkish banking sector, which eliminated most of its structural problems through the restructuring efforts implemented following the 2001 crisis, was prepared and experienced for the current crisis. Another advantage of the Turkish banking sector in the current financial crisis is the fact that Turkey does not have a mortgage sector which operates similar to the one in the US. Since such a sector is non-existent, banks have not invested in the risky derivatives in this sector and therefore the negative effects of the financial crisis on the Turkish banking system have been relatively limited.

In spite of this positive outlook in the Turkish banking sector, considering the current environment where markets are significantly globalised and economies are largely dependent on each other, it seems impossible for the Turkish economy to remain unaffected from the financial crisis. First of all, the fall in foreign demand due to the problems in foreign economies will unavoidably create problems for Turkish companies, especially for those whose sales are based on exports. On the other hand, foreign borrowing opportunities of Turkish banks have become restricted due to the difficulties of important financial institutions abroad, which may cause a constriction in the domestic loan channels and may lead to trouble for real sector companies in the mid and long terms. Besides, the decrease in the foreign currency entering into the country through hedge funds and private equity funds would mean problem in terms of foreign exchange liquidity. Last but not the least, the uncertainty environment created by the global financial crisis may have a negative effect on consumer behavior and lead to a decrease in private equity expenditures, thereby negatively affecting economic growth.

2. Importance of the Competition Policy in Intervening with the Global Financial Crisis

Under the current conditions where the crisis has turned into a threat for the whole economy, it is observed that governments have been announcing aid packages one after the other with an intention to solve the liquidity problem and reassure the markets. However, within this process, it is crucially important to strike a balance between the goal of ensuring financial stability in the short term, and the goal of protecting the competitive structure of the markets in the mid and long terms. In particular, by-passing or relaxing the application of competition policy in order to ensure economic stability within this process would create new burdens for the society in the long-run, even though it may be useful in achieving some

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1 Türkiye Ekonomi Politikaları Araştırma Vakfı (TEPAV - Economic Policy Research Foundation of Turkey), "2007-2008 Küresel Finans Krizi ve Türkiye: Etkiler ve Öneriler".
goals in the short-run. Moreover, in the case of anticompetitive market structures, the society would have to pay the bill constantly, instead of paying it periodically as is the case in economic crises.

In fact, the relationship between the measures that aim to mitigate the effects of the financial crisis and the application of competition policy is not just a trade-off between short-term goals and mid-to-long-term goals. On the contrary, an efficient application of the competition policy is an integral part of the solution in tackling, the current crisis. As the empirical studies investigating the relationship between competition policy and macro-economic goals reveal an efficient competition law implementation supports economic growth by encouraging innovation, efficiency and production. Within this framework, compromising on the application of the competition policy on the pretext of a crisis may delay the end of the recession instead of solving the problems. This is because in an environment where competition law is not implemented, the firms will prefer to limit production and increase prices, similar to the behavior of a monopolistic company, instead of focusing on innovation, efficiency and making more sales with lower prices and higher quality. This, in turn, would lead to the elimination of the existing jobs within the economy and to a decrease in the spending of consumers, which would negatively affect economic growth.

On the other hand, compromise in the implementation of the competition policy during the financial crisis, would pave the way for protection of inefficient firms. Such a situation would be harmful for the whole economy since, it would serve the existence of inefficient firms in the market and thus put the efficient firms in a disadvantageous position in competing with their rivals.

After emphasizing the importance of competition policy in intervening with the global financial crisis, critical points concerning the roles and functions of competition policy and competition authorities in the financial crisis environment will be assessed below.


When evaluating the function of competition policy and competition authorities in intervening with the financial crisis, an assessment within the framework of "control of state aids," "control of concentrations," and "control of agreements that restrict competition;" will be useful.

3.1 Control of State Aid

State aid is an important policy instrument used by the governments when making interventions in the economy. Aids granted by governments or other state organs may be functional in achieving certain economic and social goals, such as closing the gaps between various regions, encouraging research and development by companies, supporting the development of certain sectors, or rescuing and restructuring the undertakings in trouble as is the case in the current crisis. However, when those aids are not granted carefully, they may distort the level playing field in the market and thus bring some efficient firms in disadvantageous position against their rivals. This may consequently lead to the protection of inefficient firms in the market and therefore diminish the competitiveness of the economy as a whole. Therefore, "control of state aid" is established as an important pillar of competition law enforcement in many jurisdictions.

In current global crisis, the control of state aid guarantee that economic measures brought by the governments do not distort the level playing field by favoring certain undertakings or sectors. However, not all countries which implement competition policy have a regime concerning the control of state aids. For instance, in Turkey, although the Act no 4054 on the Protection of Competition came into effect in 1994, it did not introduce a mechanism concerning the control of state aids. Presently, the legislative work
on the control of state aids is proceeding, but there is no legal framework in Turkey regulating the control of state aids yet.

In countries such as Turkey where a state aid control regime does not exist, competition authorities may bear a specific responsibility within the framework of competition advocacy to ensure that industrial policies and economic measures developed by the governments concerning the crisis do not ignore competition concerns. In this vein, competition authorities may advise governments in shaping the industrial policies not only by emphasizing the importance of protecting competition for the economic development but also by giving concrete recommendations on what elements a competitive industrial policy should contain.

3.2 The Control of Concentrations

Another subject concerning the function of competition policy during the crisis is "control of concentrations". Adoption of a more flexible approach in the evaluation of concentrations during the crisis and even by-passing the supervision of competition authorities on "public interest" grounds constitutes an important debate topic in current crisis.

As it is the case in other areas of competition policy, it would be a big mistake to circumvent competition law enforcement in the evaluation of concentrations during the financial crisis on "public interest" grounds. Mergers and acquisitions made in an environment with no competition supervision would increase the concentration within the market, and the burden thereof will be paid by the consumers. At this point, one can claim that anti-competitive effects of those mergers and acquisitions authorized during the crisis may be prevented through ex-post remedies after the crisis has passed. However, we believe that this is far from a real solution. This is because, allowing anti-competitive consolidations within the economy may cause irreparable damages. On the other side, when the operational costs of ex-post supervision on competition authorities are taken into consideration together with the limited resources of those authorities, it may not be possible to conduct an effective ex-post supervision concerning the anti-competitive market structures in the whole economy.

Basically, the current case-law in competition law regarding the control of concentrations allows a "flexible" approach concerning the acquisition of undertakings which are in financial distress. As it is known, “failing firm defense” has generally been taken into consideration by competition authorities where one or more of the parties to the transaction are carrying a serious risk of going out of business. Therefore, it is possible to authorize the acquisition of undertakings in trouble without making crisis-specific amendments in the application of the current rules.

During the current crisis, Turkish Competition Authority has not yet received a merger notification incorporating the failing firm defense. However, this defense was taken into account in some of the past decisions of the Turkish Competition Authority. The first of these decisions is the Erciyas decision. In the decision concerning the acquisition of some of the assets of Toros Biracilik ve Malt Sanayi A.Ş. (Toros) by Erciyas Biracilik ve Malt San. A.Ş. (Erciyas), it can be seen that the failing firm defense was accepted, though not explicitly. It was determined that the dominant position in the market would be strengthened after the notified transaction. Nonetheless, it was stated that it would be impossible for Toros to continue its operations and that disallowing the transaction would lead to a waste of resources for both the economy of the country and for the parties. Also, within the same decision, it was found that no other undertaking wished to acquire the assets owned by Toros and that Erciyas intended to invest and increase its production capacity by acquiring the relevant assets. The transaction under consideration was authorized for the

aforementioned reasons, in spite of the possibility for a strengthening of the dominant position and a significant restriction in competition.

Another decision whereby the Competition Board accepted the “failing firm defense” was *Uzel* decision. Failing firm defense was considered in the decision concerning the acquisition by Uzel Holding A.Ş. (Inc.) (Uzel), of Efe Otomotiv Sanayi ve Ticaret A.Ş. (Efe Automotive Industry and Trade Inc.) (Efe). In this market where the parties to the acquisition produced components used in automotive sector, Uzel’s market share would reach 62% after the acquisition and there would remain two main undertakings. It was likely that there would be significant restriction of competition in the market in the post-transaction process. However, without the acquisition, Efe would most likely be excluded from the market. The decision expressly stated a view in support of “defending the failing firm”. Even though concentration would increase significantly in the relevant market post-acquisition, it was stated that Uzel’s market share could have increased even where the transaction was not authorized. Furthermore, the decision also mentioned that the production capacity of the failing undertaking would leave the market and that there were no alternative mergers and acquisitions which were less restrictive of competition. It was also stated that machinery and manpower could remain idle. Therefore, the likelihood of negative social effects in the absence of the transaction was also pointed out.

In the recently taken *Vatan Newspaper* decision which involves failing firm defense, it was decided that the acquisition of Vatan Newspaper by Doğan Group would result in the group’s market share reaching 40% in terms of net sales and 64% in terms of advertisement revenue, and that the synergy and portfolio effect brought about by the inclusion of Vatan Newspaper in the group was capable of increasing the market share even further both in terms of the number of net sales and advertisement revenue, that therefore the transaction would result in the strengthening of the dominant position of Doğan Group; however the transaction was conditionally authorized on the grounds that the indebtedness of Vatan Newspaper to Doğan Group was not a collusive act entered into for making use of failing firm defense, that the bankruptcy of Vatan Newspaper was inevitable, that there was not a better alternative buyer for the competitive structure in the market, that in the absence of the merger the brand of Vatan Newspaper would inevitably be excluded from the market and the resulting gap would most likely and substantially be filled by Doğan Group, and that the effects which restrict competition and which would arise in the market if the transaction is authorized would still arise if the transaction was not authorized.

Given the abovementioned decisions of the Competition Board, it can be said that generally four conditions are to be met for the failing firm defense to be accepted in Turkish competition law. The first condition is that the failing firm would leave the market in the near future. The second is the nonexistence of alternative mergers and acquisitions which would restrict the competition less. The third condition is the impossibility of the failing undertaking to stay in the market through methods such as its reconstruction or narrowing down its activities. The last condition is that, even in the absence of the merger and acquisition, the market share of the failing undertaking would pass to the acquiring undertaking.

While evaluating mergers and acquisitions in a crisis period, in addition to the evaluations concerning the substance of the transaction, finalization of the merger and acquisition examination in a short time is of great importance as well. This is because, ensuring that the measures taken in a crisis period produce maximum benefit depends, before all else, on the timely initiation of the measure. At this point, it might be beneficial if the competition authorities finalize the evaluations of the mergers and acquisitions notified to them as soon as possible, without waiting for the statutory timeframes, and thus ensure legal clarity for undertakings as soon as possible. But of course, an important duty rests with the undertakings in this

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3 Competition Board decision dated 20.07.2000 and numbered 00-27/294-164 (Official Gazette dated 05.03.2002 and numbered 24686).

4 Decision dated 10.3.2008 and numbered 08-23/237-75.
process too, in terms of notifying the merger and acquisition accurately and cooperating constructively with the competition authority in the evaluation process, so that the final decision can be taken within a short time.

Provided that it is limited to the crises period, another solution which can be adopted so that the expected benefit of the planned merger and acquisition takes effect promptly is the finalization of the merger and acquisition without waiting for the competition authority’s final decision. Especially where there are no serious concerns as to the merger and acquisition and where irreparable damages are not likely, adoption of such a method by competition authorities might prove beneficial for the expedition of the process. But there is no doubt that the application of this option in practice is primarily dependent on such a power being granted to competition authorities by the relevant legal arrangements. For instance, under Turkish competition law, the Competition Authority does not hold such a power.

3.3 Control of Anticompetitive Practices

Another issue which is likely to be raised in relation to the competition policy to be adopted in the financial crisis process is increasing number of anticompetitive practices but namely “crisis cartels”. Given the current period when the financial crisis reduced the demand vis-à-vis the undertakings in the market, it may be raised whether cartelization between firms can be approached more flexibly.

“Crisis cartel” defense, which may be considered in the EU competition law under very exceptional cases, has not been taken into consideration as defense in the decisions of the Turkish Competition Board so far in a decisive way. During the economic crisis which mainly broke out in financial markets and influenced rest of the economy soon, the TCA did not accept the existence of crisis as a major defense while investigating the competition infringements.

It is thought that acceptance of “crisis cartel” defense even in a financial crisis environment might result in significant damages in the markets in the medium and long term. Therefore, it is thought that there is no need to make any changes in the competition policy in relation to cartels, in a financial crisis environment.

4. Conclusion

As a conclusion, continuing to apply the competition policy in the financial crisis period is imperative both to find a way through the current crises environment and not to encounter new structural problems in the medium and long term. In this respect, competition policy enforcement is a part of the solution in preventing the negative effects of the financial crisis. On the other hand, in the current crisis when timing is determining the cost of the measures, it is of great importance that competition authorities expedite the evaluation process especially in mergers and acquisitions and the control of state aid, so that competition policy can perform its given function effectively.

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5 Under the Act No. 4054 Article 16, carrying out a merger and acquisition without the authorization of the Competition Authority is subject to administrative fines.
UNITED KINGDOM

Financial Sector Conditions and Competition Policy

1. Executive Summary

The financial services sector is characterised by a number of features such as complex products, information asymmetries and networks which pose challenges for regulators and policymakers. However, these features are not unique and have not prevented competition authorities from intervening in this sector to enforce competition law, as the UK Office of Fair Trading (OFT) and Competition Commission (CC) have done.

It has been contended that the financial services sector exhibits certain characteristics which require competition policy to be modified in relation to the financial sector. Such debates centre around whether there is a trade-off between financial stability and competition.

The OFT and CC have yet to see evidence to suggest that competition necessarily exacerbates risk taking. Firms are always incentivised to engage in profit-maximising behaviour, which in some cases may lead them to make risky decisions. It is not obvious why a particular level of competition should change this. If incentives are misaligned or there are poor levels of due diligence, then there is a risk to financial stability regardless of the level of competition.

Policy responses to the current crisis need to be properly formulated, targeted and based on an accurate diagnosis of the causes of market failure. Appropriate regulation and competition policy can link together to collectively address these instances of market failure. The two are complementary, not substitute, responses.

The appropriate policy response to market failures such as misaligned incentives in the wholesale and retail markets or where there are externalities is not to suspend or limit the application of competition law, but better regulation. The suspension or limitation of competition law creates a second market failure in the distortion, restriction and prevention of competition.

This is not to say that competition law and policy should not be flexible enough to accommodate other policy objectives. There may be compelling reasons to accept other concerns. In this changed climate, competition authorities will need to demonstrate pragmatism, but equally they will need to be effective advocates of competition within government and across the wider economy to ensure that the competition process is not compromised in the long-term, as this risks undermining the source of much of the wealth creation that came from the opening of markets to competition.

2. Overview

This paper considers a number of issues raised when laying the analytical foundations for considering the application of competition law and policy in the financial services sector:

- whether there is something unique about the financial services industry which may mean competition law should be enforced differently or possibly not at all;
• the debate on the balance between financial stability and greater levels of competition;
• how competition policy can promote efficiency in the financial services sector; and
• the position and work of the OFT and CC in this area.

3. Should the financial services industry be treated differently from other sectors?

3.1 Definition of financial services

The financial services sector is large and diverse – it is not a single market, but rather a number of individual markets encompassing a range of services across both wholesale and retail financial sectors. This diversity is reflected in the range of areas in which the OFT and CC have carried out projects. These include markets such as personal current accounts (PCAs), Small and Medium-sized Enterprise (SME) banking review, payment cards and payment protection insurance (PPI). The variety of markets suggests that it is important, as a first step, to clearly define what is meant by the financial sector. Perhaps the easiest place to start is to consider the definition used by the UK Office of National Statistics (ONS) when it measures the sector.

Under category J of its Standard Industrial Classification of Economic Activities (UK SIC(92)) codes, the ONS considers those services that can be taken to constitute the financial services sector. The ONS splits the sector into three areas of economic activity:

- **Financial intermediation**, except insurance and pension funding. This includes monetary intermediation (activities of banks and building societies) and other financial intermediation services such as financial leasing, factoring, credit granting and investment activities.
- **Insurance and pension funding** (not including State social security). This includes both life and non-life insurance.
- **Activities auxiliary to financial intermediation**. This includes activities such as brokerage and fund management.

This definition does not include professional services such as auditing and management consultancy, which are grouped under the wider 'business services' section.

According to the Institute of Financial Services London (IFSL), based on ONS data, the financial services sector’s share of UK GDP reached 9.4 per cent in 2006.\(^2\)

For the purposes of this paper, we shall adhere to this definition of financial services.

3.2 Competition policy and enforcement in the financial services sector

The financial services sector poses a number of analytical challenges for regulators and policymakers. There are complex products, different issues at wholesale and retail levels, high levels of information asymmetries, the existence of networks (including two-sided markets), after-markets and a high degree of

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1 A financial intermediary is any institution which mediates between two parties in a financial context such as a bank channeling funds between borrowers and savers. A fuller definition by the OECD can be found at http://stats.oecd.org/glossary/detail.asp?ID=972.

innovation making it difficult to keep up with changes in the sector. However, the financial services sector is not the only sector to exhibit these characteristics and these features do not in themselves make the sector distinctive or a candidate for the suspension of competition law and policy.

Like other sectors, the traditional application of competition law and policy in the financial services sector might be thought of as falling into three main components:

- investigations into abuses of dominant positions;
- investigations into cartels and other collusive practices; and
- merger control.

The first two enforcement components are very much ex post tools for addressing competitive concerns, whereas merger control is an ex ante tool. As noted by Carletti and Hartmann3 all three elements can apply to the financial services sector, like in other sectors. In the case of banking however cartels and mergers have historically seemed to play a greater role than abuses of dominant positions. The OFT has carried out a number of merger cases in the financial services sector- most recently the Lloyds TSB-HBOS merger4 (see the UK submission on the roundtable The role of competition policy in financial sector rescue and restructuring). Other examples of merger cases include Nationwide/Derbyshire building societies5, Barclays/Goldfish6 and Link/Voca7. In terms of collusive practices, the OFT is investigating interchange fees as an alleged instance of collusive practices.

In addition to these components, a key part of the OFT and CC tools are Market Studies under sections 5 of the Enterprise Act 2002 and Market Investigation References (MIRs) under section 131 of that Act. These tools allow the UK competition authorities to investigate a wider range of issues in any sector, such as transparency issues, switching costs and other features of imperfect markets. In addition, consumer issues can be explored via these tools. A selection of these investigations in the financial services sector is detailed below in the section on the work of the Competition authorities.

3.3 Distinctive features of the financial services sector

Despite the above application of competition policy, there is a widely held contention that there is something distinctive about the financial services sector which may suggest a different approach to the application of competition law and policy. As noted in a paper by Carletti and Hartmann (2002) for the European Central Bank ('ECB'), this contention is based on three features, which are argued to be distinctive to the sector:8

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• It holds a non-negligible share of households’ and firms’ wealth.
• It plays an important role in financial intermediation, in providing liquidity.
• There is a risk of financial contagion if one institution fails, which will affect not just the financial services sector, but also the wider economy: i.e., there are a large number of institutions that 'are too big to fail'.

The risk of financial contagion is worth careful consideration, particularly as it highlights a fundamental difference between financial services and other sectors. Taking the retail industry as an example: if a particular retailer experiences difficulty and exits the market, there are likely to be negative consequences in the form of a reduced number of competitors as well as adverse effects on suppliers. However, unlike in the financial services sector, the consequences of the firm exiting the retail market will not be systemic - suppliers will be able to supply to the remaining retailers. In contrast, in the financial services sector because of the ways products are structured, the exit of one major player can have severe effects, even for those firms that remain in the market. As an example, the unwinding of securities and other products offered by Lehman Brothers after its move into administration had much wider market (and economy-wide) effects.

Taking these features together, it has been argued by authors such as Keeley (1990), that competition policy should be applied differently to the financial services sector. The argument is that the strict application of competition law and policy may impede the ability of institutions and markets to function effectively thereby potentially impairing financial stability.

4. Financial stability and competition policy

The notion that competition law and policy should be applied differently in the financial services sector has typically centred around the debate on whether there is a trade-off between financial stability and competition.

In a speech by Lucas Papademos, Vice President of the ECB, financial stability was described as a 'condition in which the financial system is capable of withstanding shocks and the unravelling of financial imbalances, and is expected to do so for the foreseeable future'.

Naturally, regulatory authorities wish to maintain financial stability and develop financial resilience to shocks. The unravelling of financial stability can impair financial intermediation to such an extent that savings can no longer be allocated to profitable investment opportunities, which has much wider economic consequences. As Papademos points out, understood this way, financial stability means identifying the main sources of risk and vulnerability, assessing whether the financial system is facilitating a smooth and efficient reallocation of financial resources from savers to investors and evaluating whether financial risks are being appropriately priced and efficiently managed.

The existence of a relationship between financial stability and the degree of competition has been explored in the past in a number of studies. Carletti and Vives (2008) have reviewed the literature on perceived trade-offs between financial stability and the degree of competition in the banking sector.

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9 Speech by Lucas Papademos, Vice President of the ECB at the Third conference of the Monetary Stability Foundation on “Challenges to the financial system – ageing and low growth” Frankfurt am Main, 7 July 2006.

While their focus is banking, much of their reasoning could be arguably extended to the financial services sector as a whole. The authors point out that while early work (including Keeley (1990)) argued that increased competition might lead to increased fragility in the financial sector, in particular in banking, the broad set of studies in this area does not lead to clear cut conclusions on the existence of a trade off between financial stability and competition.

In the UK, Capie (1995) has studied the relationship between stability and efficiency in the banking sector between 1890 and 1940 (see below). During this period the market structure moved from one of many banks to an oligopolistic structure, but demonstrated a high level of stability. While the increase in concentration in the banking sector may not correspond to a decrease in the competitiveness of the sector (indeed some might argue that higher concentration might be caused by greater competition), it is possible that different degrees of competition were present in this sector over time. If this was the case, this might imply that different degrees of competition in banking can both be associated with stability.

These studies suggest that regulation should be applied to limit the adverse consequences arising from intense competition in the interests of stability, for example by limiting entry or 'correcting' banks' incentives to take risks and innovate.

More recent empirical studies suggest that the negative link between competition and stability in financial services may not be as robust as originally claimed. Carletti and Hartmann (2002) cite empirical research by Staikouras and Wood (2000) as being consistent with the hypothesis of no trade-off between competition and stability. They conclude from a survey of empirical literature that 'there does not appear to be a single ever-valid relationship between competition and stability'.

Carletti and Vives also contend that it is plausible to think that excessive risk-taking by banks may be curtailed by reputational concerns – the presence of private costs of failure to managers – being greater than achieving greater market share.

Further, the effects of competition on risk-taking may be mitigated by good regulatory design. Nagarajan and Sealey (1995) focus on how charter values are determined. Certain regulatory policies may affect charter values. For example, a poorly designed forbearance policy might lead to very high charter values (high rents) which provoke excessive risk taking.11

Carletti and Vives (2008) conclude by accepting that, given the intrinsic fragility of the banking sector, there may be a potential trade-off between competition and stability. However, recent papers quoted in their literature review have questioned the robustness of this link, empirically as well as theoretically, though questions remain as to whether a 'banking exception' in competition policy exists. Carletti and Hartmann (2002) also note that there are many scenarios in which increased competition reduces asset risk-taking or increases the ability of the interbank market to insure against liquidity shocks. While ill-designed policies may reinforce a trade-off between competition and stability (e.g. through risk-insensitive deposit insurance, static capital requirements or non-optimal forbearance), theory suggests that there are policy options that would ensure competitive and stable systems. Ultimately, any link between stability and competition is likely to be heavily coloured by each country’s regulatory, legal and institutional circumstances.

In sum, academic studies do not provide a clear cut answer on the existence of a trade off between the degree of competition and the stability of the banking sector. Even if a trade-off was shown to exist, the

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11 Forbearance policy refers to lenders temporarily not enforcing a debt when it is due. If a regulator allows for a very short forbearance policy period or none at all, then banks may feel the incentive to lend more recklessly, knowing they can enforce the debt much quicker.
academic studies that posit it would not in themselves imply a need for reduced competition policy scrutiny of the financial sectors. On the contrary, some studies\(^\text{12}\) point out that the most likely causes of any such trade-off\(^\text{13}\) might be appropriately addressed with specific regulation. This might actually imply more involvement by competition authorities.

5. **Competition policy can promote efficiency in the financial services sector**

Efficiency in the financial services sector is not dissimilar to efficiency in other sectors of the economy. It can be defined in terms of static efficiency – how much output can be produced from a given stock of resources at a certain point in time – and dynamic efficiency which involves the development of new technologies or processes that can improve productivity.

Clearly competition policy has a role to play in promoting efficiency. As OFT research\(^\text{14}\) has shown, competition policy can improve efficiency (and thereby productivity) through three mechanisms:

- Within firm[s] effects: competition causing firms to improve their own efficiency (reduce levels of x-inefficiency\(^\text{15}\));
- Between firm effects: competition ensures that low productivity firms are replaced by high productivity firms in the market; and
- Innovation: competition provides an incentive to innovate and capture dynamic efficiency benefits.

Within the financial services sector, competition policy can be used to promote efficiency via increases in transparency and information. Increased transparency affects both consumers and suppliers. Better informed consumers will be able to better compare between supplier offerings, and act as competitive drivers causing firms to innovate and improve efficiency. Other policy activities such as lowering entry barriers (subject to prudential regulation conditions) will also promote efficiency through between firm effects.

6. **The position and work of the UK competition authorities in this sector**

6.1 **General position**

The UK competition authorities’ general position is that, regardless of the type of market, competition remains the best mechanism for delivering optimal outcomes for both consumers and business. Effective competition can provide greater choice and drives efficiency, productivity and innovation. The OFT and CC have yet to see compelling evidence to suggest that the application of competition law needs to be dampened for the benefit of financial stability.

\(^\text{12}\) See Matutes and Vives (2000), and Hellman et al. (2000) [cited in Carletti and Vivez (2008)].

\(^\text{13}\) Such as competition incentivising banks to “take more risks”, following Keeley (1990).

\(^\text{14}\) There is a strong body of evidence that competition enhances efficiency and productivity. See for example Productivity and Competition – An OFT perspective on the productivity debate January 2007 OFT 887.

\(^\text{15}\) X-inefficiencies refer to inefficiencies that may arise due to lack of competitive pressure. The OECD notes that x-inefficiencies can include wasteful expenditures such as maintenance of excess capacity, luxurious executive benefits, political lobbying seeking protection and favourable regulations, and litigation. An OECD definition can be found at: [http://stats.oecd.org/glossary/detail.asp?ID=3333](http://stats.oecd.org/glossary/detail.asp?ID=3333).
More generally, any discussion between financial stability and competition policy should pay close attention to the incentives of market players. If incentives are misaligned, then there is a risk to financial stability regardless of the level of competition. In particular, with reference to the current crisis:

- The incentive structures for the largest financial institutions are not clearly articulated. If an institution considered 'too big to fail' does fail and is rescued (for example via nationalisation), then both the management and the owners (shareholders) will lose out. In this sense, the incentive structures have failed, not the competition process.

- It does not seem correct to suggest that competition necessarily exacerbates risk taking. Firms are always incentivised to engage in profit-maximising behaviour, which in some cases may lead them to make risky decisions. It is not obvious why a particular level of competition should change this.

- Arguably one of the causes of the current financial crisis has been a lack of due diligence at the wholesale level, allowing excessive lending/securitisation, which has in turn misaligned incentives between the wholesale and retail level.

The market failure in these circumstances is a mismatch of incentives or incorrect signalling – not an 'excess' amount of competition. As mentioned above, suspending competition law itself creates a market failure and this is not a sound policy response to an existing market failure.

That is not to say that other concerns should be subordinate to competition policy. In the current context and the immediate short-run, there is a need to be flexible in order to accommodate wider interests.

Nonetheless, competition law should not be modified in a way which will impair the competitive process in the longer term when economic conditions improve, thereby harming the upswing.

State intervention to rescue the financial sector from systemic failure can be decisive, but should not be used as an excuse to rollback competition policy. As noted by the OFT’s Chief Executive John Fingleton, policy responses to the 'credit crunch' should be based on a proper and thorough diagnosis of the causes and responses should be targeted 'micro-surgeries' rather than 'drastic amputations'. There is a real risk that if one mistakes regulatory failure for market failure risks, one undermines the source of much of the wealth creation that came from the opening of markets to competition.

6.2 The work of the UK competition authorities in this sector

The OFT and the CC have carried out a number of investigations into the financial services sector to address these issues and to improve consumer welfare. Some examples in the retail market are given below.

- The OFT PCA Market Study. This study highlighted concerns about low levels of transparency, unfair charges and switching in the PCA market. Work is currently ongoing to address these concerns.

- The OFT report into the effects on competition arising from public support to Northern Rock;

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16 Competition policy in troubled times, John Fingleton, OFT, 20 January 2009.
• The OFT MIR to the Competition Commission on PPI and subsequent advice. The OFT made an MIR to the CC on the basis of the market exhibiting anti-competitive features such as a point-of-sale advantage experienced by distributors meaning there is little competitive pressure at the key point at which the consumer buys the insurance. The CC found that the current market structure led to a failure to compete by PPI providers on price or non-price features, with a resulting consumer detriment significantly in excess of £200 million per year. It has imposed remedies including a prohibition on distributors and intermediaries on selling PPI within seven days of the sale of a credit product, and a prohibition on selling PPI policies where the total premium is paid upfront as one payment (“single-premium policies”).

• The OFT MIR to the Competition Commission on store cards and the CC investigation.

• The CC market investigation into PCA banking services in Northern Ireland.

The complexities of the financial services sector have not prevented competition authorities from taking action when appropriate. Indeed, as noted above, the UK competition authorities have examined two-sided markets in the payment cards market and have addressed issues of information asymmetries and after-markets in the cases of PCAs and PPI.

Some examples of the OFT's work in wholesale markets are given below.

• The OFT MIR to the Competition Commission on SME banking; and the CC investigation.

• The OFT investigation into MasterCard and Visa: under the Competition Act (1998) and Article 81 of the EC Treaty, the OFT is currently investigating elements of the payment card market.

• Financial Services and Markets Act: under section 303 of that Act the OFT has considered a number of applications for recognition status in recent years, the latest being the approval of ICE Clear USA Inc.

The projects mentioned above were all carried out or begun in a period of relative financial stability. However, the PPI investigation finished during the current period of upheaval in the financial sector, and several parties to the investigation said that the CC’s analysis, based on data covering a period of stable economic circumstances, could not be relied upon. The CC considered these arguments but concluded that

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18 Forthcoming. A commitment has been made in the House of Commons that 'the OFT will publish an annual report assessing any competitive implications of the public support for Northern Rock…’ See Hansard 21 February 2008, consideration of Lords amendment no.3 to the Banking (Special Provisions) Bill.


22 The OFT has a special role under the Financial Services and Markets Act 2000, for keeping under review the regulating provisions and practices of the FSA for significantly adverse effects on competition. Under section 303 of the FSMA, the OFT is required to report on whether the regulatory provisions (or a combination of the regulatory provisions) of organisations, which apply to the FSA for 'recognition' status, have a significantly adverse effect on competition.
the economic downturn would not clearly result in a sufficiently different outcome from its analyses to warrant a change in its approach to remedies.

The OFT and CC – and other competition authorities – will need to adapt quickly to changing priorities, and to display a degree of pragmatism by recognising occasions when other policy interests may over-ride competition policy. At the same time, the role of competition authorities as advocates of competition within government, with fair-dealing businesses and beyond has never been more important: failing to tackle powerful private vested interests will have significant costs in the future. As noted by Peter Freeman, when there is conflict between competition and other policy imperatives, then it is for the competition authorities to explain clearly the case for competition-based measures and not to abandon the cause just because ‘times are hard’.23

Given the current economic climate and recent turbulence in financial markets it may be the case that in the future there is a shift in competition authorities' focus. This is discussed in more depth in the UK submission to the roundtable Going forward: Adaptation of competition rules, processes and institutions to current financial sector issues.

7. **Conclusion**

The UK competition authorities’ view is that, even in times of economic turbulence, competition policy has a clear role to play in ensuring that markets work as effectively as possible. There will be occasions when there are other factors which might over-ride the normal application of competition policy.

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23 Competition Policy in interesting times, Peter Freeman, CC, 2 December 2008.
UNITED KINGDOM

The Role of Competition Policy in Financial Sector Rescue and Restructuring

1. Executive Summary

1.1 Section One: Application of the failing firm defence during periods of financial distress or economic retrenchment

1.1.1 The UK competition authorities’ approach to analysing ‘failing firm’ claims

‘Failing firm’ claims are ones where merging parties argue that the target business will exit the market without the merger; any harm to competition should therefore not be attributed to the merger.

1.1.2 Criteria to assess absence of causal link between the merger and any competitive harm

As is appropriate for a phase I body, the UK Office of Fair Trading (OFT) has explicitly adopted a stringent approach in such cases out of recognition that counterfactuals are easily the subject of self-serving speculation – relatively easily alleged but difficult, given information asymmetries, to verify independently.

The OFT will only clear a transaction based on ‘failing firm’ claims where it has sufficient compelling evidence that all of the following conditions are met:

- **Inevitable exit of the target business absent the merger:** often because the business in question is in a parlous financial situation. Having demonstrably explored such options, there is no serious prospect of the target business being reorganised.

- **No realistic substantially less anti-competitive alternative:** there are no other realistic purchasers whose acquisition of the target business would produce a substantially better outcome for competition. Alternatively, in some cases it may be better for competition that the target business fails and the remaining players compete for its market share and assets rather than these being transferred wholesale to a single purchaser.

At Phase II the CC similarly considers whether or not the firm is failing as part of its assessment of the counterfactual. The considerations are similar to those of the OFT though the Competition Commission’s (CC) decision as to the appropriate counterfactual is based upon its expectation of the most likely outcome in the market.

The above criteria demonstrate that it is important for the OFT in its merger assessment not merely that the target business would have exited the market, but also that the merger in question does not raise competition concerns compared to other realistic scenarios following exit of the target business.
1.1.3 Application of the 'failing firm' criteria in the prevailing economic and market conditions

The UK competition authorities will take account of the prevailing economic and market conditions when assessing evidence put forward by merging parties. A contextual evaluation of evidence will be important in relation to, for example:

- the inevitability of the target business exiting the market because of, for example, cash flow difficulties or an inability to raise capital; and
- the realistic availability of alternative purchasers for the target business as a result, for example, of difficulties in raising investment finance.

Therefore, while the prevailing economic and market conditions will be relevant to the UK competition authorities’ consideration, they neither alter the analytical framework nor relax the thresholds that apply to the authorities’ decision making. In particular, even if the authorities are satisfied that the firm is a failing firm, they will consider whether there was a less anti-competitive merger.

In its recent restatement of the ‘failing firm’ criteria, the OFT said:-

- There is no good reason why owners of a struggling business should be permitted to sell to another close competitor in the market simply because it is prepared to pay the highest price for the target business.

- Mere assertion that there is only one purchaser for a failing business will not suffice; compelling evidence must be provided.

1.1.4 Case study: Lloyds TSB and Halifax-Bank of Scotland

Merger principles, including the ‘failing firm’ test, are applied no differently to mergers within the financial sector than to any other industry.

In its report regarding the merger of two of the largest retail banks in the UK, Lloyds TSB and Halifax-Bank of Scotland (Lloyds/HBOS), the OFT considered that the application of the failing firm defence was not appropriate given that it was not realistic to consider that HBOS would have been allowed to fail. Instead the OFT considered a range of possible counterfactuals besides a failing firm, concluding that the two most realistic scenarios, which would be expected to occur sequentially, were:

- Government would not have allowed HBOS to fail, and rather would have intervened in the short term with some form of rescue package. In these circumstances, the OFT believed it realistic to consider that HBOS would still be able to exert some competitive pressure in the market.

- In the medium to longer-term, Government would have withdrawn its support, leaving either a fully independent HBOS once more, or an HBOS in the hands of a ‘no overlap’ purchaser. In these circumstances, HBOS would constitute a significant player in the market place in the medium term.

In his subsequent decision of 31 October 2008, the Secretary of State decided not to refer the merger to the CC. This decision was not taken on protectionist grounds, e.g. the creation of a “national champion”, but rather on the basis that the public interest. In this case, the risk to financial stability outweighs any potential competition concerns. The UK’s merger regime explicitly provides for Government to intervene on public interest grounds. Lloyds/HBOS was the first case—in light of the exceptional economic and
financial conditions—where the Government intervened and subsequently cleared a merger that raised competition concerns using an expedited (i.e. without reference to the CC) and explicit process on public interest grounds.

1.2 Section Two: minimising market distortions in the market place

1.2.1 Types of remedies

The UK competition authorities have a number of tools for addressing competition issues in the economy, including in the financial services sector. These can be split into ex ante tools and ex post tools. The principal ex ante tool is merger control ('first phase' by the OFT and 'second phase' by the CC under the Enterprise Act 2002). The principal ex post tools are market studies and antitrust investigations (both tools can be applied by the OFT—the former under the Enterprise Act, the latter under the Competition Act 1998), and market investigations (which are undertaken by the CC under the Enterprise Act).

The UK competition authorities have a preference for structural remedies, where these are available, over behavioural remedies in relation to merger control, since they tend to be more clear-cut in addressing concerns and to be more easily administered than behavioural remedies. These benefits of structural remedies also apply in relation to market studies and market investigations.

The application of remedies to alleviate competition concerns in a time of financial instability is more challenging as there is greater uncertainty and greater potential for unintended consequences. Further, remedies which address competition concerns need to take into account other polices designed to address the instability itself. In the case of ex ante remedies, a climate of economic instability may mean structural remedies become harder to apply. In the case of ex post remedies designed to address competition concerns that have already arisen, the challenge to competition authorities during a period of financial instability is to make appropriate remedies that account for both static and dynamic concerns and to consider trade-offs, while being sensitive to the prevailing economic climate.

However, in doing so the UK authorities also need to be mindful of whether the competition concern being remedied is independent of the financial instability, or is a consequence of it. If it is the former, then competition remedies should be taken forward. If it is the latter, then it may be better addressed by wider policy measures combating the instability as opposed to the use of specific competition policy tools.

On the basis of the above, behavioural remedies that address competition concerns might, at the margin, be more appropriate in some cases during a period of financial instability since they can be reviewed and revised as the market evolves. However, this should not mean that competition authorities should not consider structural remedies for competition concerns in a time of financial instability. If they can be devised in a manner appropriate for the case at hand and demonstrate an awareness of market conditions, then they can be equally effective to create conditions for effective competition.

1.2.2 The impact of state intervention

One of the consequences in the UK of the ongoing financial crisis has been an increase in instances of direct state intervention in the financial services sector, mainly banking. The main interventions have been the taking into public ownership of certain banks, or components of banks, injections of capital into banks (in exchange for shareholdings) and guarantee/insurance schemes to stimulate lending.

State ownership does not necessarily equate to State management, however, although it may be the case that banks with significant State shareholding are perceived by the market or consumers as having some form of unfair competitive advantage. If this is the case, then certain behavioural and structural
remedies or monitoring may be appropriate to ensure that the banks do not exploit State ownership for anti-
competitive purposes.

State interventions through guarantee/insurance schemes are more complex. If these schemes are
offered to the whole market, then there should not be any competitive concerns, though there may be a risk
that these guarantees protect inefficient firms from leaving the market. However, if interventions are
selective, then there is the potential for anti-competitive effects and for potential conflicts with EC rules on
State aid.

Intervention to rescue the financial system from systematic collapse in exceptional circumstances can
be crucial, but should not be seen as a reason to suspend the importance of competition in other sectors,
either via State aid, anti-competitive mergers or cartels.

2. Section One: application of the failing firm defence during periods of financial distress or
economic retrenchment

2.1 Introduction

This section first describes the OFT’s position regarding its approach to cases where merging parties
seek to persuade it that a merger raising competition concerns should be cleared on ‘failing firm’ grounds,
or because the assets are inevitably exiting the market.

Although the OFT believes that its approach to 'failing firm' claims is capable of being applied
whatever the market conditions, the financial sector may be uniquely prone to the adverse effects of
systemic risk and loss of consumer confidence in periods of economic retrenchment.

Consequently, this section then describes how, in some circumstances, the UK Government may
intervene in mergers to take public interest grounds into account, as well as competition considerations.
Ensuring financial stability was recently included as one of three circumstances when Government may
intervene on public interest grounds (the others being ensuring national security and ensuring plurality of
the media).

This section lastly includes a case study on the recent merger of two of the UK's largest retail banks,
Lloyds and HBOS, which illustrates the intersection in the financial sector of the OFT's application of its
approach to 'failing firm' claims and the UK Government's approach to the new financial stability public
interest consideration.

In reading this section, it is important to note that it applies to the position of the OFT to ‘failing firm’
claims and not that of the CC. This is because in the one application by the Government of the financial
stability public interest consideration, the Secretary of State did not refer the Lloyds/HBOS merger to the
CC, so there is no intersection between its application and the CC's position on 'failing firm' claims.

2.2 OFT’s approach to analysing ‘failing firm’ claims

The following is a summary of the OFT’s recent publication restating its position on 'failing firm'
claims as set out in its existing guidance and decisional practice. That restatement did not constitute new
guidance that departs from or relaxes the OFT's basic approach, because the OFT considered that the
applicable principles are capable of being applied whatever the economic and market conditions. The OFT
published that restatement for two reasons. First, because it considered that consistent and transparent

1 OFT Restatement of OFT’s position regarding acquisitions of ‘failing firms’, December 2008 (OFT1047).
application of the criteria it uses to approach such cases is the best means of ensuring that businesses can continue to assess regulatory risk whatever the economic and market conditions. And second, in the light of the current financial climate, to highlight its willingness to give informal advice to merging parties on its application of those criteria. 'Failing firm' claims are, in essence, ones that the target business will exit the market without the merger; any harm to competition should therefore not be attributed to the merger. As the UK's substantial lessening of competition ('SLC') test requires that the merger be the cause of competitive harm, the OFT has always believed that meritorious 'failing firm' cases should be allowed to proceed relatively swiftly through clearance by the OFT, even where for example the target business was not yet in liquidation or administration, notwithstanding that there have been few such cases to date.

2.3 **Criteria to assess absence of causal link between the merger and any SLC**

The OFT's duty under the Enterprise Act 2002 (the Act) to refer a merger to the CC for further investigation arises where the merger creates only a realistic prospect of an SLC, not just where the merger does so on the balance of probabilities. Where merging parties argue that prevailing conditions of competition are not the appropriate benchmark to assess merger effects because the target business would have exited the market absent the merger in any event, the OFT has explicitly adopted a stringent approach in such cases out of recognition that such non-standard counterfactuals are easily the subject of self-serving speculation.

The hurdle set by the OFT's 'realistic prospect of an SLC' test therefore requires it to take a cautious approach, requiring compelling evidence where merging parties present 'failing firm' claims. In particular, the OFT will only clear a transaction based on 'failing firm' claims where the following two conditions are both met:

- **Inevitable exit of the target business absent the merger**

  There are two limbs to this condition. First, that the business in question would have inevitably exited the market in the near future. This will often be because the business is in a parlous financial situation, even if not yet in liquidation, but may be for some other reason such as a change in the seller's corporate strategy. Second, that having demonstrably explored such options, there is no serious prospect of the target business being reorganised. This takes account of the reality that even businesses in receivership often survive and recover.

- **No realistic and substantially less anti-competitive alternative**

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2 'Failing firm' arguments may alternatively apply to the acquiring business. Whether referring to the target or the acquiring business, the OFT has taken the view in its decisional practice that 'failing firm' arguments may apply to an entire business or to divisions or stand-alone business units (for example, individual retail stores). The term 'target business' is used as shorthand in this context.

3 The OFT has applied the 'failing firm' defence four times under the Enterprise Act 2002: (i) *Anticipated acquisition by First West Yorkshire Limited of Black Prince Buses Limited* 26 May 2005 (failing firm defence met in respect of a bus business as a whole); (ii) *Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson)* 11 December 2007 (failing firm defence met in respect of individual local grocery stores); (iii) *Completed acquisition by the CdMG group of companies of Ferryways NV and Searoad Stevedores NV* 24 January 2008 (failing firm defence met in respect of target business); and (iv) *Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd* 15 April 2008 (failing firm defence met in respect of an individual DIY store).

4 As clarified in *IBA Health Ltd v OFT* [2004] EWCA Civ 142.
There are no other realistic purchasers whose acquisition of the target business would produce a substantially better outcome for competition. Even if such a purchaser may not pay the seller as high a purchase price or otherwise benefit the target business, the OFT will take into account any realistic prospect of alternative offers above liquidation value. Alternatively, in some cases it may also be better for competition that the target business fails and that the remaining players compete for its market share and assets rather than that these be transferred wholesale to a single purchaser.

2.4 Application of the 'failing firm' criteria in prevailing economic and market conditions

The OFT will take account of prevailing economic and market conditions when assessing evidence put forward by merging parties. However, as a legal and policy matter, the OFT will not, regardless of prevailing economic and market conditions, relax the 'sufficient compelling evidence' standard required to demonstrate that a merger between close competitors is not itself the cause of any SLC for three reasons:

- Although merging parties may find their businesses under financial pressure as a result of changing conditions, their customers may well be in a similar position. Weakening evidentiary standards to allow anti-competitive mergers is likely to bolster operators with market power at one level of the supply chain, only to increase pressure downstream as a result of anti-competitive price increases, or other anti-competitive conduct, resulting from the merger. The creation of, or increase in, market power in UK markets, where this is far from inevitable, will also fail to serve productivity of the UK economy well in the longer term.

- There is no good reason why owners of struggling businesses should be permitted to sell to another close competitor in the market simply because it is prepared to pay the highest price for the target business. Businesses wishing to exit the market must be aware of the implications of choosing to try to sell to a close competitor. To advance a 'failing firm' argument, they will need to adduce evidence to demonstrate the absence of any realistic and substantially less anti-competitive alternative purchaser. In terms of execution risk for a deal, the quickest and least risky sale is to a purchaser that raises no competition issues, if such a purchaser exists, even if the price which that purchaser offers is lower than that which was offered by a close competitor.

- In situations where the target business is failing and there is genuinely only one purchaser for the business in question, merging parties must be aware that they will need to provide compelling evidence of this to the OFT if they are to avoid a reference to the CC. Mere assertion that this is the case will not suffice.

The OFT’s 'realistic prospect' threshold is intentionally a lower and more cautious threshold for an SLC finding than that applied by the CC after more extensive investigation. While applying a similar analytical approach, the difference in the test has implications for the two authorities’ approach to the counterfactual. In particular, the prevailing conditions of competition will generally be the relevant starting point for the OFT when making the counterfactual assessment. The CC will consider what it thinks is the most likely outcome in the market under investigation and will define the counterfactual based upon its expectation. Hence from an evidentiary perspective it may be relatively more difficult to establish a failing firm counterfactual at the OFT stage than at the CC stage.
2.5 UK public interest considerations in mergers

As explained above, the Act allows for an assessment to be made of qualifying mergers on competition grounds by the OFT and, if referred, the CC. However, the Act also allows for the possibility of Government intervention in the normal process on certain specified public interest grounds.5

Under the Act, the Secretary of State has the ability to issue a public interest intervention notice (PIIN) in the case of mergers that meet the jurisdictional thresholds, which have public interest implications and which the OFT has not referred to the CC. At the time of the announcement of the Lloyds/HBOS merger on 18 September 2008 (discussed below), public interest considerations were limited to national security (including public security), and plurality and other considerations relating to newspapers and other media.

The Secretary of State therefore issued a PIIN on the merger on 18 September that specified 'the stability of the UK financial system' as a public interest consideration under the Act. This new public interest consideration was subsequently laid before Parliament on 7 October for its approval. It was then approved by the House of Lords on 16 October and by the House of Commons on 22 October, and came into force on 24 October 2008, the date the OFT submitted its report on the merger to the Secretary of State as requested by him.

When a PIIN is issued by the Secretary of State, the OFT publishes an invitation to comment seeking third party views on both any competition and public interest issues. Following its own internal review, the OFT then provides binding advice to the Secretary of State on a date specified by him on jurisdictional and competition issues. The OFT may also advise on the public interest considerations that are relevant to the Secretary of State's decision on reference, and must, other than in media cases, pass to the Secretary of State a summary of any representations it has received that relate to these public interest matters.6 The OFT also informs the Secretary of State as to whether it would be appropriate to deal with competition concerns by way of undertakings in lieu of reference. The Secretary of State then subsequently makes a judgment on the outcome of the case in the light of the OFT's advice.

In doing so, the Secretary of State may make a reference to the CC, if he believes:

- that the merger gives rise to a realistic prospect of an SLC and, combined with the relevant public interest consideration(s), operates against the public interest; or
- while there is no SLC arising from the merger, that the public interest considerations are such that the merger operates against the public interest.7

Conversely, the Secretary of State may decide not to make a reference to the CC, if he believes that the OFT's findings on SLC are outweighed by one or more public interest considerations.

In either event, the Secretary of State is bound by the OFT's competition findings.

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5 See chapter 8 of the OFT’s Mergers – Procedural Guidance (OFT 526) for a full description of the procedure in public interest cases. What follows here is a summary only.

6 In cases raising media public interest issues, Ofcom (the UK's communications regulator) will provide a separate report on issues of media plurality and diversity.

7 If a reference is made on public interest grounds (with or without competition grounds) the Secretary of State will also make the final decision on the merger following the CC's report.
2.6 Case study: Lloyds-TSB and Halifax-Bank of Scotland

On 18 September 2008, Lloyds announced its intention to acquire HBOS. The parties were two of the largest banks in the UK, whose activities covered retail, commercial and corporate banking. However, the parties overlapped most closely in the supply of personal current accounts (PCAs), banking services to small and medium-sized enterprises (SMEs), and mortgages—in each of which they were two of the largest five banks in the UK.

In its report to the Secretary of State on 24 October 2008, the OFT concluded that the merger gave rise to a realistic prospect of an SLC in the supply of PCAs, banking services to SMEs and mortgages. In doing so, the OFT considered that merger principles, including the 'failing firm' criteria, are applied no differently to mergers within the financial sector as they would to any other industry. In particular, the OFT considered that the application of the failing firm defence was not appropriate given that it was not realistic to consider that HBOS would have been allowed to fail by the UK Government (or that its assets would have been allowed to exit the market). Accordingly, the OFT did not consider it realistic to consider that the failure/exit of HBOS (or its assets) would inevitably have occurred, and therefore ruled out failure/exit as a possible substitute counterfactual. Instead the OFT considered a range of possible counterfactuals besides a failing firm, concluding that the two most realistic, which would be expected to occur sequentially, were:

- Government would not have allowed HBOS to fail, and rather would have intervened in the short term with some form of rescue package. In these circumstances, the OFT believed it realistic to consider that HBOS would still be able to exert some competitive pressure in the market (although it recognised the possibility that HBOS might, at least in the short term, be a weaker force when compared to the HBOS prior to the current financial crisis).

- In the medium to longer-term, Government would have withdrawn its support, leaving either a fully independent HBOS once more, or an HBOS in the hands of a 'no overlap' purchaser. In these circumstances, HBOS would constitute a significant player in the market place in the medium term.

In his subsequent decision of 31 October 2008, the Secretary of State decided not to refer the merger to the CC. This decision was not taken on protectionist grounds, e.g. the creation of a “national champion”, but rather (due to the risk to financial stability) because the merger did not operate against the public interest. In particular, the Secretary of State took into account the views of the Tripartite Authorities (the Bank of England, the Treasury and the Financial Services Authority—the UK financial services regulator) that the merger also provided an effective, market based means of restoring the stability of HBOS and helped to secure the stability of the UK financial system as a whole. On balance, therefore, the Secretary of State concluded that ensuring the stability of the UK financial system outweighed the competition concerns identified by the OFT and that the public interest was best served by clearing the merger.

This interaction of the OFT's treatment of 'failing firm' claims in this case and of the Secretary of State's treatment of the financial stability public interest consideration suggests that the OFT's approach to 'failing firm' claims is capable of being applied whatever the market conditions, even in the financial sector where consumer confidence and systemic risk may be particularly important. In the case of Lloyds/HBOS, the OFT found that the application of the failing firm defence was not appropriate (based on the finding that HBOS would not have been allowed to fail). Instead, the risk to financial stability was addressed using a pre-existing mechanism under the UK's merger regime for dealing with public interest considerations, and changes to that mechanism are subject to the normal democratic parliamentary process for changing laws.
Further, in periods of financial distress, widespread adverse effects of the loss of consumer confidence and of systemic risk in the financial sector can occur very quickly. This perhaps contrasts to other sectors where loss of consumer confidence and, in particular, systemic risk are likely to have less serious consequences. The European Commission has reacted to these risks by granting derogations from the suspensory effect of its merger regulation in a number of cases (although it has still gone on to review these cases under its normal review periods and against its normal competition test). The position in the UK is different in two material ways.

First, the UK’s merger regime is voluntary which means that parties are able to complete their merger at any time (and therefore potentially mitigate against loss of consumer confidence/systemic risk).

Second, and arguably more important, the regime explicitly provides for cases raising financial stability issues via an expedited merger control procedure (i.e. the Secretary of State can—in exceptional circumstances—clear a deal without an in-depth CC inquiry), as in Lloyds/HBOS. Such an expedited, explicit procedure arguably can restore confidence and mitigate systemic risk while providing the Secretary of State with proper consideration of the competitive effects of the merger.

3. **Section Two: minimising distortions to competition in the financial sector**

3.1 **Introduction**

This section briefly describes the principal types of remedies to competition problems in the financial sector that are available to the UK competition authorities, the OFT and the CC. This section then discusses the use of state intervention in the financial sector, which has increased in the UK as a result of financial instability. In doing so, this section emphasises trade-offs in using both so as to minimise distortions to competition.

3.2 **Types of remedies**

The UK competition authorities have a number of tools for addressing competition issues in the economy, including in the financial services sector. These can be split into ex ante tools and ex post tools. The principal ex ante tool is merger control ("first phase" by the OFT and "second phase" by the CC under the Enterprise Act 2002). The principal ex post tools are market studies and antitrust investigations (both tools can be applied by the OFT—the former under the Enterprise Act, the latter under the Competition Act 1998), and market investigations (which are undertaken by the CC under the Enterprise Act).

A number of remedies, which can be behavioural or structural, can result from these tools. A behavioural remedy is normally an ongoing measure that regulates behaviour by a firm or firms, such as price caps and supply commitments. A structural remedy is typically a one-off measure, such as divestment of shares or assets. The two types of remedy can be combined, for example where a behavioural remedy is necessary in order to support a structural remedy.

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8 Other ex ante tools include the recognition of trading exchanges, and the review of practices and regulations under the Financial Services and Markets Act 2000.

9 Other ex post tools include the Consumer Credit Act 2006 and other parts of the Financial Services and Markets Act 2000.

10 The focus of this discussion is on remedies. This is distinct from fines or penalties. A remedy is typically more a directional action to prevent an infringement occurring, whereas a fine/penalty acts more as a deterrent or is a punishment when competition law is violated.
The remedies that result from these tools differ between the two UK competition authorities.

- An adverse finding by the OFT under the Competition Act means that the conduct is unlawful. The OFT can therefore impose legally-enforceable directions to stop the unlawful conduct. The OFT can also impose fines of up to 10 per cent of annual worldwide turnover.\(^{11}\)

- The OFT may accept (but not impose) behavioural or structural undertakings in lieu of reference to the CC under the Enterprise Act: where a merger raises the realistic prospect of a substantial lessening of competition (SLC); and where the OFT has reasonable grounds for suspecting that any feature, or combination of features, of a market is preventing, restricting, or distorting competition.

- By contrast, the CC may impose behavioural or structural remedies in two situations under the Enterprise Act: where a merger gives rise to an SLC; and where any feature, or combination of features, of a market prevents, restricts or distorts competition.

The UK competition authorities, in common with many others, have a preference for structural remedies, where these are available, over behavioural remedies in relation to merger control, for two reasons. Firstly, they tend to be more clear-cut in addressing concerns. Structural remedies can directly address any market power arising from the merger by restoring the pre-merger market structure. Secondly, structural remedies also tend to be more easily administered than behavioural remedies. These benefits of structural remedies also apply in relation to market studies and market investigations. However, depending on the nature of the competition concern identified, an appropriate structural remedy may not exist, so measures to address supplier or consumer behaviour may be appropriate.

3.3 Remedies in periods of financial instability

Competition concerns can still arise in periods of financial instability. Indeed, they may be more pronounced or have the potential to be longer lasting. The application of remedies to alleviate competition concerns in a time of financial instability is more challenging as there is greater uncertainty and potential for unintended consequences. Further, remedies which address competition concerns need to be aware of other policies designed to address the instability itself. There may be trade-offs and tensions between the two.

In the case of ex ante remedies to address competition concerns a climate of economic instability may mean structural remedies become harder to apply. Companies may find it harder to dispose of assets as part of a structural remedy, or to do so within the timescales that would usually be considered appropriate, because they cannot find a buyer. It may also be harder to devise remedies when the market itself is being realigned and a remedy that does not acknowledge this may lead to a sub-optimal equilibrium in the new state of the world. When devising ex ante remedies there is a need to be sensitive to the prevailing economic climate, although the general policy preference for structural measures should remain.

\(^{11}\) There are other consequences of breaching UK competition law that are not directly imposed by the OFT. It is a criminal offence for individuals to engage dishonestly in cartels. Individuals found guilty by a court can be imprisoned for up to five years and face an unlimited fine. Company directors whose companies breach competition law may be subject to competition disqualification orders imposed by the OFT, which will prevent them from being involved in the management of a company for up to 15 years. Damages claims can also be brought by third parties and by consumer groups on behalf of named consumers against businesses that breach competition law.
Turning to ex post remedies designed to address competition concerns that have already arisen, under a period of financial instability the challenge to competition authorities is to make appropriate remedies that account for both static and dynamic concerns and consider trade-offs. Again, when devising ex post remedies, there is a need to be sensitive to the prevailing economic climate.

However, in doing so the UK authorities will also need to be mindful of whether the competition concern being remedied is independent of the financial instability, or is a consequence of it.

If it is the former, then competition remedies should be taken forward. For example, in the PPI market investigation, whilst no party suggested that its overall financial stability would be jeopardized by remedies (though several said they would consider exiting the market for PPI if the proposed remedy package was implemented), several parties to the investigation said that the CC should take a cautious approach to remedies in light of the prevailing economic circumstances. In that case the CC concluded that, if anything, in an economic downturn the case for intervention to address a competition problem in PPI could be seen to be more pressing, since the current high prices discourage PPI uptake and could result in consumers being uncovered at a time of increased risk.\(^\text{12}\)

If it is the latter, then it may be better addressed by wider policy measures combating the instability as opposed to specific competition policy tools.

On the basis of the above, behavioural remedies to address competition concerns might, at the margin, be more appropriate in some cases, in a time of financial instability. Applying behavioural remedies have the advantage of not being static; they can be reviewed and revised as the market evolves.

However, this should not mean that competition authorities should not consider structural remedies for competition concerns in a time of financial instability. If they can be devised in a manner appropriate for the case at hand and demonstrate an awareness of market conditions, then they can be equally effective. In the PPI market investigation the CC’s package of remedies includes structural elements – such as prohibitions on selling policies where the premium is paid in one lump sum at the beginning of the policy, and on selling PPI bundled with merchandise protection insurance unless PPI is also sold on its own. The CC concluded that, despite the current financial instability, these remedies were needed to create conditions for effective competition between providers.

### 3.4 State intervention in periods of financial instability

One of the consequences in the UK of the ongoing financial crisis has been an increase in instances of direct state intervention in the financial services sector, mainly banking. The main interventions have been the taking into temporary public ownership of certain banks, or components of banks, injections of capital in banks (in exchange for shareholdings) and guarantee/insurance schemes to stimulate lending.

In the absence of explicit reasons to expect a linkage in a firm's competitive strategy between the identity of its owner(s) and the nature of their control over its competitive actions (for example, where a competing firm's owners have material influence over its pricing decisions), the identity of a firm's owner(s) is not normally relevant to competition policy. This is the case with banks which are owned by the State or have a significant State shareholding. In the UK, the recent capital injections have led to the

State having shareholdings in the banks, but day-to-day management and strategy is not carried out by Government. That is, State ownership should not necessarily equate to State management.

However, it may be the case that banks that have a significant State shareholding are perceived by the market and consumers as having features that allow them to gain some form of unfair competitive advantage. If this is the case, then certain behavioural and structural remedies or monitoring may be appropriate to ensure that the banks do not exploit State ownership for anti-competitive purposes.

State interventions through guarantee/insurance schemes are more complex. If these schemes are offered to the whole market, then there should not be any competitive concerns, though there may be a risk that these guarantees protect inefficient firms from leaving the market. However, if this intervention is selective, then there is the potential for anti-competitive effects and potentially conflicts with EC rules on State aid.

3.5 **State intervention vis-à-vis anti-competitive restrictions**

In a recent speech on 'Competition policy in troubled times', OFT Chief Executive John Fingleton discussed state intervention vis-à-vis anti-competitive restrictions, such as anti-competitive mergers and cartels.

In doing so, he commented that 'intervention to rescue the financial system from systemic collapse in exceptional circumstances can be crucial, but should not be seen as a reason to suspend the importance of competition in other sectors, either via State aid, anti-competitive mergers or cartels. Subsidies are rarely ideal: they are costly for the taxpayer, can prop-up less efficient firms, create dependency, and ultimately damage competitive incentives. Restrictions on competition are worse. In addition to higher consumer prices and the inefficiency, they are less transparent and can result in permanent changes to market structure. Ad hoc changes to the competition rules can also remove consistency and predictability for business, with additional harm to efficiency. Naturally, incumbent business will rarely object to subsidies or restrictions on competition.'
UNITED KINGDOM

Challenges for Competition Policy in Periods of Retrenchment

1. Executive Summary

This paper discusses some of the challenges for merger control in a period of retrenchment. Other elements of competition policy are discussed in the UK’s submission to the roundtable Going forward: Adaptation of competition rules, processes and institutions to current financial sector issues.

1.1 Section One: The impact of the ‘credit crunch’ and economic downturn on consolidation and competition

The ‘credit crunch’ and recession have had a profound impact on commercial activity in many markets, particularly those where firms have been reliant on the commercial money markets to borrow. In this section we consider some of the likely impacts of such changes to competition and the issues that these changes pose for competition agencies within the context of merger control.

1.1.1 Competition between firms

The ‘credit crunch’ and economic downturn can undoubtedly negatively impact on the commercial activities of firms. However, only in exceptional circumstances would this impact be likely to lessen competition concerns arising from market consolidation (for example, in ‘failing firm’ scenarios where the business in question would exit the market without the merger, and therefore any harm to competition should not be attributed to the merger). For instance, a fall in market demand is likely to intensify competition between firms for the remaining custom. Therefore there remains a prospect of a loss of competition through merger activity.

Of course, in some cases prevailing market conditions may impede a firm’s commercial activities – perhaps through a lack of credit or fall in customer demand – and reduce the constraint it exerts on competitors. However, such impacts may be market-wide; in such circumstances, competition between all firms will be muted, and so the importance of retaining the competition that remains becomes more important, not less.

1.1.2 The threat of new entry

The willingness and ability of firms to enter certain markets may be negatively impacted by, among other things, lower profitability and more restricted wholesale funding (although falling interest rates may partially counteract this by making low return investments profitable which otherwise would not have been). The resulting (potentially) higher barriers to entry in the UK mortgage market played a role in the Office of Fair Trading’s (OFT) finding that the merger of Lloyds TSB and Halifax-Bank of Scotland
(Lloyds/HBOS) presented a realistic prospect of a substantial lessening of competition (SLC) in that market.¹

1.1.3 Constraint from imports

The competitive constraint exerted by imports on domestic producers can be sensitive to relative currency and commodity price movements. During periods of macroeconomic volatility, competition agencies will need to consider carefully whether imports will continue to exert their prevailing constraint on domestic producers, especially where this constraint may be vulnerable to slight market developments (for example, currency fluctuations). Competition authorities may face pressure for ex post action where the constraint on merged parties from imports has now diminished.

1.1.4 Presence of countervailing buyer power

The ‘credit crunch’ and economic downturn will almost certainly impact on the competitive dynamic of negotiations between firms and their customers. However, the overall impact could be either to strengthen the hand of the firm or alternatively that of its customers. A customer’s buyer power may increase if, against a backdrop of falling industry demand, its individual demand remains robust. Conversely, a customer’s negotiating position may suffer if its own demand also falls, or if adverse market conditions negatively impact on the likelihood of new entry (including the viability of sponsoring entry).

1.1.5 Risk of coordination

Coordinated behaviour may (or may not) become more likely to emerge following a merger in light of adverse market conditions. On the one hand, the prior exit of other firms or dampening of the countervailing factors to coordination will increase the risk of coordination emerging post-merger. Conversely, greater economic volatility will reduce transparency within the market (e.g. as a result of changing cost bases) and, all else equal, make successful coordination strategies harder to maintain.

1.1.6 Looking forward

Of course, competition agencies are not in a position to predict for how long the effects of the ‘credit crunch’ or recession are likely to persist. Agencies therefore need to test thoroughly claims that any impact of the credit crisis that may exacerbate competitive concerns can safely be assumed to be temporary. Conversely, agencies need to be careful in clearing mergers where there is a possibility that any mitigating factors to its competitive concerns may only be temporary.

1.2 Section Two: Implications for the viability of divestment in the current climate

In common with many competition authorities, the UK’s competition agencies (the OFT and Competition Commission (CC)) have a preference for structural remedies over behavioural remedies as they tend to be more clear-cut in addressing competition concerns.

Structural remedies can directly address the issues from which competition problems flow by restoring the pre-merger market structure. They also tend to engage fewer resources of competition authorities in terms of ongoing monitoring and enforcement. They are not without their limitations –

¹ See the OFT report to the Secretary of State for Business Enterprise and Regulatory Reform, 24 October 2008.
potential problems can arise because of information asymmetry (asset, purchaser and composition risk) and incentive compatibility between the competition authority and the merging party. Nevertheless, the UK competition authorities, for example, are increasingly demonstrating a flexible and sophisticated approach to structural remedies, such as imposing upfront buyer requirements, which can help to mitigate some of these shortfalls.

The OFT and CC generally have a strong preference for ex ante structural remedies in merger control, principally on the grounds of clear-cut effectiveness and administrability. However, in a period of financial instability, it may be harder to divest the assets the acquisition of which has given rise to competition problems. This may make it necessary to consider behavioural remedies as a second-best alternative, in the limited number of cases for which structural measures are not feasible. However, the disadvantages of behavioural remedies remain, and it may be more difficult to specify, monitor and enforce effective behavioural measures during periods of instability and change.

During the current crisis it may not always be possible to find buyers of divested assets at those prices which prevailed before the crisis. This raises the issue of whether a minimum or market sale price of divested assets should be relevant to an assessment of appropriate remedies. In the OFT’s view, this should not be a relevant factor, and in rare cases a negative premium may need to be applied to a divestment (although in such situations agencies would need to ensure that the purchaser has the right incentives to run the business). An interesting question is whether all agencies should take this approach or whether it reflects, at least in part, the OFT’s position as a first phase review body. The possibility that no buyer might step forward, even at a negative price, is plausible. However, in the OFT’s experience, such occasions have in practice been rare to date and the successes of large divestment programs in the past are an encouraging sign that the risks of not finding buyers remain small. For completed mergers, the CC will not normally take account of costs or losses that will be incurred by the merger parties as a result of a divestiture remedy as it is open to the parties to make merger proposals conditional on competition authorities’ approval. It is for the parties concerned to assess whether there is a risk that a completed merger would be subject to an SLC finding and the CC would expect this risk to be reflected in the agreed acquisition price. Since the cost of divestiture is, in essence, avoidable, the CC will not, in the absence of exceptional circumstances, accept that the cost of divestiture should be considered in selecting remedies.

The UK competition authorities’ choice of preferred undertakings will continue to be determined on a case-by-case basis, and does not inevitably preclude the offer of behavioural remedies in future where they may genuinely represent the better undertaking with which to safeguard competition and efficiency savings; such occasions, however, are expected to be rare.

To the extent that a lack of credit is hindering M&A activity – and if this is harming the wider economy – the correct policy response may be for governments to look for ways to increase access to credit, rather than for competition agencies to alter their approach to remedies. In particular, in the UK the competition agencies are under a statutory obligation to have regard to the need for any remedy they accept to remedy the SLC as comprehensively as is reasonable and practicable.

2. Section One: The impact of the ‘credit crunch’ and economic downturn on consolidation and competition

The ‘credit crunch’ and recession have had a profound impact on commercial activity in many markets, particularly those activities where firms have been reliant on the commercial money markets to borrow. In this section we consider some of the likely impacts of such changes to competition in the market place and the issues that these changes pose for competition authorities within the context of merger control.
In summary, competition agencies need to be cautious when considering arguments put forward by merging parties regarding their limited ability to compete as a result of prevailing economic and financial conditions such that a merger between them, which in more benign conditions may have raised competition concerns, should be permitted.

By contrast, competition agencies need to consider how to account for any impact of prevailing economic and financial conditions on the potential for countervailing constraints such as the threat of new entry or imports to address any prima facie competition concerns. Generally speaking, competition agencies need to be cautious in accepting arguments from merging parties based on current ‘exceptional’ market conditions where volatility and uncertainty is such that it is much more difficult than in more ‘normal’ conditions to predict how markets will develop in the short to medium term. A cautious approach may apply in particular to the OFT, the UK’s first phase merger review body.

2.1 Competition between firms

Prevailing economic and financial conditions, including a lack of availability of credit and depressed customer demand, may negatively impact upon a firm’s commercial activity. Competition agencies may (increasingly) face arguments from merging parties regarding the impact of prevailing conditions on their ability to compete (in particular with each other). For example parties may argue that what otherwise might have constituted a problematic merger (in more benign conditions) should be cleared on grounds that any loss of rivalry is not significant.

The most obvious example of this is where parties argue the ‘failing firm’ defence – that is, the relevant business will exit the market without the merger, and therefore any harm to competition should therefore not be attributed to the merger (see the UK submission to the roundtable Crisis: the role of competition policy in financial sector rescue and restructuring for further detail on the failing firm defence). In this regard, it is interesting to consider whether firms that are facing viability issues in the current economic and financial circumstances may be more likely to have good long term business models than those that face viability issues in more robust times. As such, it may be the case that they should be expected to come out of administration in reasonable condition. On the other hand, it also means that it would seem more important to preserve such firms in the market (for the long term). Both of these points might be expected to factor into an assessment of the failing firm defence.

The issue also arises in cases where the relevant business is not failing (or inevitably exiting the market) but where its ability to compete has been impeded by prevailing economic and market conditions and, merging parties argue, should therefore be taken into account when assessing the loss of rivalry from the merger.

Competition agencies need to be cautious in accepting such arguments in the absence of compelling evidence. For instance, it does not automatically follow that a firm suffering from adverse market conditions will exert a diminished constraint on its competitors. Indeed, as consumer demand within a

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2 In its competition assessment under the Enterprise Act 2002, the OFT is required to make a reference to the CC where it believes that it is or may be the case that the creation of the relevant merger situation has resulted or may be expected to result in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services (sections 22 and 33 of the Act). The OFT interprets this as meaning that the test for reference will be met if it has a reasonable belief, objectively justified by relevant facts, that there is a ‘realistic prospect’ that the merger will lessen competition substantially (OFT Guidance, paragraph 3.2). By contrast, the CC is required to decide whether the relevant merger situation has resulted or may be expected to result in a substantial lessening of competition (sections 35 and 36 of the Act).
market declines, it may be the case that incumbent firms compete more vigorously for the remaining market in what may be a fight for survival.

Even where adverse conditions - such as a lack of credit or more generally a lack of demand - might feasibly limit a firm’s commercial activities, this impact may not be firm specific. Indeed, if a lack of credit were to have the effect of effectively muting competition between all firms within a market, then the importance of retaining the competition that remained would potentially become more important, not less.

2.2 The threat of new entry

The ‘credit crunch’ and economic downturn may exacerbate competition concerns in some markets through negatively affecting firms’ willingness and ability to enter.

For instance, a firm’s willingness to enter a market may decline where profits within that market have become less attractive, perhaps as a result of a decline in customer demand (although falling interest rates may partially counteract this by making low return investments profitable which otherwise would not have been). The ability of firms to enter certain markets may also be more limited under more restricted wholesale funding, particularly where potential entrants, who may previously have been able and willing to enter on leveraged business models, can no longer do so.

The latter was relevant during the OFT’s Lloyds/HBOS report. Within the UK mortgage market, the merging parties’ pre-merger combined share levels, at [20-30]\(^3\) per cent, would not necessarily have been cause for serious concerns prior to the ‘credit crunch’. In particular, it was a relatively fragmented market (especially compared to the personal current account market) with likely sufficient mitigating competitive constraints in the form of low barriers to entry and ease of customer switching.

However, the OFT considered that more restricted and costly wholesale funding as a result of the ‘credit crunch’ would likely prevent potential lenders from entering the market who previously would have done so on the basis of easy and cheap access to credit. Therefore any constraint previously exerted on established mortgage providers by these potential entrants would be removed as a result of the ‘credit crunch’. Furthermore, existing competition within the market may decline if any recent entrants, especially those reliant on highly leveraged business models, exit the market due to persistent low levels of liquidity.

The OFT concluded – in part because of these higher barriers to entry – that the ability and incentive of incumbent mortgage lenders to exploit their customer bases, rather than to compete for new customers, was likely to have increased. This incentive was likely to increase for a mortgage lender in line with the size of its customer base (that is, the larger a mortgage lender's customer base, the greater its incentive to exploit that base and not to compete for new customers). Therefore, under these changed conditions, a merger of the largest and third largest mortgage providers raised significant concerns over the merged entity’s incentive to compete for new custom and to offer favorable terms to its combined customer base.

2.3 The risk of exit

While barriers to entry may increase during a recession, there is also a general risk of exit. As such, mergers that look as though their impact on competition may be relatively limited (and therefore are cleared on the basis that the market will remain relatively unconcentrated post-merger, for example, because three significant competitors will remain, a ‘4:3’) may in fact – with hindsight – raise competition concerns (such that it perhaps should not have been cleared) because a competitor has subsequently exited (making the merger a 3:2).

\(^3\) Exact market share has been redacted.
This raises an interesting question of whether competition agencies should consider the likely viability of competitors when carrying out merger analysis. However, this can be a very difficult analysis to carry out, particularly in more benign economic times when even inefficient businesses may be profitable.

2.4 **Constraint from imports**

Competition agencies should be careful to consider any impact from the ‘credit crunch’ and economic downturn on the competitive constraint that imports exert on domestic producers, through their impact on currency values and commodity prices (particularly oil).

Currency and commodity price movements are exceptionally difficult to forecast even during relatively benign economic conditions. Yet periods of economic and financial turmoil can be accompanied by particularly pronounced currency and commodity price movements. These in turn may dramatically increase or decrease the competitive constraint imports impose on domestic producers.

A particular issue for the UK’s competition agencies at present is how to assess the recent decline in the strength of the UK’s currency and the impact that this may have on the level of imports into the UK. For example, could the decline in the strength of the UK’s currency mean that a market that may have been wider than the UK as recently as last year has become national in scope? Or, should competition agencies treat shifts in flows consequent on change in prevailing relative prices (e.g. as between the UK and continental Europe) as evidence in favour of a broad geographic market rather than evidence against it? More generally, could the pressure for ex post action by competition authorities’ increase in those markets where the competitive constraint from imports on merged parties has subsequently diminished?

2.5 **Presence of countervailing buyer power**

The ‘credit crunch’ and economic downturn may also be expected to alter the dynamics of negotiations between firms and their customers.

For instance, competition agencies may reasonably assume that, all else remaining equal, depressed demand within a market may increase an individual customer’s buyer power, to the extent that its own individual demand has not diminished. This is because suppliers may be willing to offer more favourable terms in an attempt to attract a greater share of a declining market. Relatively large customers may be expected to see the greatest increase in their negotiating clout, especially if their custom is large enough to sustain a supplier through the downturn.

However, there are countervailing factors that may diminish, or even outweigh, this increase in negotiating strength. A customer’s negotiating hand is likely to be weakened to the extent that its own demand also declines. Even if an individual customer’s demand remains constant, its buyer power is likely to suffer if the downturn leads to suppliers exiting the market or the threat of entry (including sponsored entry) declines.

In its Lloyds/HBOS report, the OFT found that by reducing the size of the UK mortgage market, and therefore the range of options available for borrowers, the ‘credit crunch’ had caused lenders to focus on very low risk lending. As a consequence, it had become very difficult for borrowers that were perceived to be even marginally more 'risky' to obtain mortgages, and the costs of switching mortgage provider had increased significantly.

The ‘credit crunch’ and economic downturn will undoubtedly impact on negotiations between firms and their customers. However, whether customers’ negotiating positions are improved, and if so, to what degree, will need to be considered on a case-by-case basis.
2.6 **Risk of coordination**

As already discussed, the ‘credit crunch’ and economic downturn could feasibly reduce the strength of competition between firms. But adverse market conditions can also, under certain conditions, increase the likelihood of co-ordinated behaviour arising.

For example, if the economic downturn results in some firms exiting a market, then a competition agency will generally consider that the risk that a merger may facilitate coordination will increase, although the extent of that risk will clearly depend on the profile of the remaining market. The risk of coordination may also increase to the extent that the ‘credit crunch’ acts to reduce countervailing factors to coordination such as buyer power and the threat of new entry, as discussed above.

However, within a period of greater economic volatility, particularly with respect to prices and output, market transparency (for example, due to changing cost bases) is likely to decrease. A lack of market transparency will tend to make coordination less likely to prevail, since it becomes more difficult for firms to reach the terms of coordination and more difficult to detect ‘cheating’ behaviour.

Consequently, whether the overall risk of coordination emerging post merger increases due to the ‘credit crunch’ depends upon these two countervailing arguments, and would need to be considered on a case-by-case basis.

2.7 **Looking forward**

We conclude this section by considering how competition agencies might factor in changes to the competitive landscape when it is not in a position to predict for how long the effects of the ‘credit crunch’ or the recession are likely to persist.

Agencies will need to be cautious in clearing a merger where it is possible that any mitigating factors to its competitive concerns may only be temporary. Conversely, agencies will need to test evidence thoroughly before concluding that any impact of the credit crisis that may exacerbate competitive concerns can safely be considered to be only a temporary phenomenon.

For example, in the UK the OFT identified competition concerns in relation to the mortgage market in Lloyds/HBOS in light of (i) uncertainty over how long the effects of the ‘credit crunch’ were likely to last; (ii) evidence that suggested that the shift to very risk averse business models by mortgage lenders (which had the effect of raising barriers to entry) may be a longer-lasting effect; and (iii) the enormous importance of the mortgage business to the UK economy, which meant that the cost of a wrongful clearance would have been very high.

3. **Section Two: Implications for the viability of divestment in the current climate**

3.1 **Practice and preference of using divestment over behavioural undertakings/remedies**

Where its merger investigations identify a realistic prospect of competition concerns, the OFT may accept undertakings proposed by the parties in lieu of referral to the CC. In situations where a merger is referred for a detailed investigation by the CC, and the CC identifies competition concerns on the balance of probabilities, the CC may consider alternative remedies in lieu of outright prohibition. Undertakings and remedies can be structural or behavioural in nature, and are intended to alleviate competition concerns while allowing the original transaction to proceed in modified form.

Since 2002 (when the Enterprise Act came into effect) the UK’s competition agencies have accepted behavioural (as compared to structural) undertakings in a small minority of merger cases. This reflects the
strong preference of the UK competition authorities – shared by many competition authorities including the EC and the US agencies – for structural remedies (i.e. divestments) over behavioural remedies.

3.2 Why competition authorities typically favour divestment over behavioural remedies

A merger involves a structural change to a market. When competition concerns arise from a merger, in some cases, divestments can be implemented that directly address those specific structural issues from which competition problems flow by restoring competition to pre-merger levels. In other words, the remedy ‘cures’ the problem.

By contrast, the effectiveness of behavioural remedies may be limited because they do not address the underlying cause of the competition problem by restoring the pre-merger structure and only address its effects. In other words, the remedy merely ‘treats’ the problem. In most cases, behavioural undertakings are designed to moderate the scope for the merged firm to exploit its post-merger market power to the detriment of competition in the market (some behavioural remedies – such as access remedies – are designed to promote competition by lowering barriers to entry).

Behavioural remedies can also introduce unwanted distortions into the market by placing constraints on firms' behaviour. Price regulation, for instance, may preclude price discrimination by the firm, which may be the most efficient response to prevailing market conditions. Behavioural remedies can therefore incur deadweight losses through the subsequent misallocation of resources.

Overseeing the sale of assets as part of a divestment will also tend to engage fewer of a competition agency’s resources than would an ongoing commitment to monitor and regulate a firm as part of a behavioural remedy.

Divestments, as a form of undertakings, are not themselves without limitations. Potential problems can arise due to asset risk (i.e. is the package sufficiently comprehensive for the purchaser to compete effectively?), purchaser risk (i.e. are there any third parties interested in and capable from a competition standpoint of purchasing the asset?) or composition risk (i.e. the possibility of the seller intentionally deteriorating the quality of the asset prior to on-sale). There may also be problems of incentive compatibility between the competition agency and the seller – whereas the agency will be keen to restore competition to pre-merger levels, the seller may be incentivised to sell to the least competitive buyer such that it will face reduced competition in the market post-merger. This latter concern demonstrates the importance of the purchaser approval process.

In certain circumstances, behavioural remedies can offer advantages over divestment remedies. For instance, when a merger-specific lessening of competition is expected to be temporary, a behavioural remedy may be more suitable because it can later be reversed when the risk of harm has passed. This approach thereby avoids the risk of losing the merger specific structural efficiencies potentially resulting from a permanent divestment.

Nevertheless, for the reasons outlined, the UK’s competition authorities favour divestments over behavioural remedies. Indeed, recent application by the OFT demonstrates an increasingly flexible and sophisticated approach to structural remedies that help to mitigate some of the potential concerns highlighted.

For instance, in its decision in CGL/Somerfield (2008), a merger of two large national grocery retailers ('supermarkets'), the OFT identified over 100 local markets in which the parties' supermarkets overlapped and in which the transaction raised local competition concerns. Given concerns over the availability of buyers for divestment stores in a sub-set of these local areas, the OFT imposed an ‘up-front buyer’ requirement in relation to these particular stores prior to accepting the package of divestments. This
meant that the parties were required to identify, and sign divestment agreements with, onsale purchasers for these divestment stores before the OFT accepted undertakings and therefore terminated its duty to refer. In effect, this helped to side step the purchaser risk identified above through ensuring that divested stores were purchased by buyers with sufficient expertise, resources and incentives to maintain pre-merger levels of competition.

3.3 The impact of the ‘credit crunch’ on the desirability and effectiveness of divestments and behavioural remedies

As the economic crisis and economic downturn have intensified, it might be asked whether competition agencies should consider modifying their use of remedies and in particular consider using behavioural remedies instead of divestments.

For example, finding buyers of assets at prices prevailing before the financial crisis and economic downturn may not always be possible, especially given that the divestment price of assets in some markets is likely to have been negatively affected by current market conditions. Indeed, potential buyers may see less value from assets where a market is entering a period of slower growth or even retrenchment. It may also be the case that more limited access to credit may constrain a potential buyer's ability to offer an amount reflecting the previous market value placed on the asset.

By contrast, many other factors besides the economic cycle and availability of credit are known to impact the valuation of divestments. For instance, the presence of a very limited number of potentially suitable purchasers may negatively impact on the sale price. Indeed, in some instances a seller may be able to dispose of its assets only for a negative premium, effectively paying the buyer to take the divested assets in order for the wider transaction to proceed.

A pertinent question for a competition agency is whether the value to the seller from divesting assets should be part of its assessment of whether to accept a remedy. The OFT’s view is that such a consideration should be irrelevant, even where the 'value' to the seller is a negative premium (although in such a case an agency must be careful to ensure that despite not paying for the assets the divestment purchaser nevertheless has an incentive to run the business going forward). Consequently, firms wishing to exit the market must be aware of the potential financial implications in terms of divestments of choosing to try to sell to a close competitor.

Similarly, for completed mergers, the CC will not normally take account of costs or losses that will be incurred by the merger parties as a result of a divestiture remedy as it is open to the parties to make merger proposals conditional on competition authorities’ approval. It is for the parties concerned to assess whether there is a risk that a completed merger would be subject to an SLC finding and the CC would expect this risk to be reflected in the agreed acquisition price. Since the cost of divestiture is, in essence, avoidable, the CC will not accept, in the absence of exceptional circumstances, that the cost of divestiture should be considered in selecting remedies.

The possibility that a buyer of divested assets might not come forward, even at negative price, remains a possibility. And it is plausible that this risk may have increased during the credit crunch. In addition, competition agencies need to be alert to the fact that there may be an increased risk in a downturn that buyers of divested assets do not actually do anything with the assets (such that the remedy is ineffective in terms of resolving the identified competition concerns). While it is common practice for competition agencies to conduct a ‘purchaser approval’ process to confirm the buyer’s intentions, experience, and financial ability to operate a divested asset, the UK competition authorities understand that it is not standard practice for agencies to require buyers to commit to operate the asset for a defined period of time (the rationale being that such a commitment would equate to some form of behavioural
commitment that could create unwanted distortions into the market). A question for agencies during these difficult economic times is whether a change in policy may be required to mitigate the risk of buyers not operating their divested assets.

Behavioural remedies, however, present their own set of additional problems in difficult economic and financial times. In the event that prices are skewed by a lack of availability of credit, behavioural remedies may themselves be increasingly difficult to implement. For example volatile prices in some markets may make setting benchmark prices more difficult if current prices proved to be exceptional. Similarly indexation becomes much more difficult where relative prices of inputs (e.g. commodities) are relatively turbulent.

3.4 Looking forward

The UK competition authorities’ choice of preferred remedy will continue to be determined on a case-by-case basis. The strong preference for structural remedies does not preclude the use of behavioural remedies in future where it represents the better undertaking with which to safeguard competition and efficiency savings. However, based on past experience, the number of cases where this is the case is likely to be limited.

The UK’s competition agencies are committed to setting clear and consistent rules regarding mergers which allow firms to minimise their chances of spending time and money on transactions that are subsequently blocked for competition reasons. This in turn creates substantial cost-savings for business by avoiding the waste of resources and time associated with unsuccessful merger bids.

To the extent that a lack of credit is hindering M&A activity – and if this is harming the wider economy – then the correct policy response may be for Government to look for ways to increase access to credit, rather than for the UK to implement merger control in a manner that would fail to serve the productivity of the UK economy in the longer term.
UNITED KINGDOM

Adaptation of Competition Rules, Processes and Institutions to Current Financial Sector Issues

1. Executive Summary

The UK competition regime includes a variety of tools in order to ‘make markets work well for consumers.’ The combination of such tools means that the UK authorities are well placed to deal with a whole range of both competition and consumer issues that may arise in the financial sector.

The financial sector plays a particularly important role in the economy (see the discussion in the UK submission to the roundtable Principles: Financial sector conditions and competition policy). As a result, any problems in financial markets can result in high levels of consumer detriment. Further, financial services are unique in that there is a systematic contagion risk if firms fail.

Looking to the future, it is likely that there will be an increase in the number of market failures in financial services markets. During any recession some firms exit the market and if there are low levels of new entry into the market then consumers will have fewer providers to choose from; this reduction may lead to a fall in competition between the remaining firms. It is also likely that the expected rise in unemployment and mortgage repossessions will lead to an increase in the number of vulnerable consumers.

The effect of state ownership on competition and on consumer welfare depends on a number of factors and will be, in part, determined by: the extent of state ownership of firms and in the relevant sector, the way in which the state organises its ownership interest and the extent to which the state chooses to exercise its ownership interest. Competition authorities should focus on possible anti-competitive conduct of firms and whether that conduct is causing consumer detriment as a result of its actions.

Competition authorities can use their work to improve competitive conditions in financial markets. The UK authorities are well placed to deal with emerging issues in financial markets using their existing competition tools in order to address competition and consumer issues and improving competitive conditions in financial markets.

These improvements can be made through recommendations and remedies as a result of the work the authorities do. These remedies could include the introduction of structural or behavioural undertakings by financial institutions which are designed to shift markets to a more competitive equilibrium.

The Office of Fair Trading’s (OFT) market studies tool is particularly useful as it is a flexible tool that can be used to address market failures which are not covered by the prohibitions against cartels and abuses of a dominant position. The current market studies tool appears to be sufficiently versatile to deal with most market failures based on the current situation and it is unlikely that it will need to be revised in the future. Recent examples of market studies in the financial markets include the OFT work on payment protection insurance (PPI)¹, which led to a market investigation reference to the Competition Commission (CC) in February 2007. The CC published its final report, complete with remedies, in January 2009.

The statutory powers granted to the OFT and CC under the Competition Act 1998 (CA98), Enterprise Act 2002 (EA02) and the Financial Services and Markets Act 2000 (FSMA) will remain important tools in helping to improve and maintain competitive conditions in all markets.

In addition, there may be an increased role for competition advocacy in the future to make sure that competition concerns remain on the agenda when new regulations and policy initiatives are being designed.

Competition authorities must focus on promoting competition through well-targeted interventions but they need to be mindful of the situation in the wider economy and the wider policy concerns Government may want to address. Competition agencies should work collaboratively with other Government departments and financial regulators to ensure that policies relating to the financial sector are formulated having considered the competitive effects of such policies.

Strong and regular interaction between all institutions is the best way of promoting competition to regulators and Government. This interaction is likely to become even more important over the medium to long-term as competition agencies around the world seek to respond to the effects of the current financial crisis. Competition authorities would be well advised, however, not to neglect their primary role of protecting and promoting competition, in the interests of consumers, in bad times as well as in good.

2. **Introduction**

This paper considers if, and how, competition rules, institutions and processes should change over the medium and long term once the worst of a financial crisis appears to be over.

The paper is structured as follows:

- outline of the existing competition rules and tools available to the UK authorities, existing processes and institutional relationships.
- discussion of the possible changes that might occur in the financial services sector as a result of the financial crisis.
- consideration of whether the OFT and CC’s rules and tools, institutional relationships and processes may need to be revised in the light of changes that might occur in the financial service sector.
- outline of how competition policy can improve the competitive conditions in the financial sector by reference to examples of recent work of the UK authorities on financial services.
- brief consideration of how state ownership may affect competition.

We conclude that while there may be a change in the use of particular tools available to the OFT and the CC the current competition and consumer regime in the UK is sufficiently robust and flexible to deal with the situation in the financial sector over the medium and long term.

3. **Current arrangements**

3.1 **Competition rules, tools and processes**

The UK competition regime includes a number of tools which can be used to addresses anti-competitive conduct and market failures which harm consumers. These tools include:
• CA98 investigations,
• market studies,
• CC market investigations,
• merger control,
• consumer policy and consumer enforcement work,
• competition scrutiny under the FSMA and
• competition advocacy.

The UK has two competition agencies that can consider competition issues in the financial services sector: the OFT\(^2\) and the CC.\(^3\) The OFT and the CC’s powers to intervene are outlined below. In addition, the competition authorities’ have a competition scrutiny role under special legislation which is discussed from paragraph 45 onwards.

### 3.1.1 Competition Act 1998

The CA98 prohibits:

- anti-competitive agreements, decisions and concerted practices which affect trade in the UK, and
- abuses of a dominant position in a market, which affect trade in the UK.

In addition the OFT can also conduct an investigation under Articles 81 and 82 of the EC Treaty which contain similar prohibitions to the CA98 but apply to trade between Member States of the European Union.

Such investigations are only relevant where the OFT has reasonable grounds to suspect that the relevant firms have behaved illegally. Adverse effects on competition that do not involve either agreements between undertakings or abuses of dominance are beyond the reach of the CA98 and Articles 81 and 82 EC.

### 3.1.2 OFT market studies

Market studies\(^4\) are conducted by the OFT and their purpose is to examine whether a market is working effectively and to identify all aspects of market failure, including consumer detriment (the OFT’s recent market studies in the financial sector, for example into PPI\(^5\) and Personal Current Accounts which

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\(^2\) The OFT is the UK consumer and competition authority which has the following powers: to conduct CA98 investigations, phase I merger reviews, market studies, enforce consumer legislation and it has a general consumer and competition advocacy remit to Government.

\(^3\) The CC conducts phase II merger reviews and market investigations, following a reference from the OFT. Market investigation references to the CC can also be made by sector regulators and in some cases by Ministers.

\(^4\) Market studies do not involve the application of Chapter I or Chapter II of the CA98, instead they are performed pursuant to section 5 of the Enterprise Act 2002.

are discussed further below, are good example of this), competition issues, and the effect of Government regulations. As well as looking at particular economic markets, the studies can look at current practices in the market.

Market studies can lead to a range of possible outcomes including:

- giving the market a clean bill of health,
- making recommendations to the Government or regulators,
- commencing a CA98 investigation or other enforcement action, for example, enforcement under the Unfair Terms in Consumer Contracts Regulations 1999,
- campaigns to promote consumer education and awareness,
- market investigation reference (MIR) to the CC.

Where the OFT makes a MIR, the CC conducts a detailed investigation of the market or practice in question (see paragraphs 24 and 25).

The OFT considers that market studies have a number of unique benefits that make them a very flexible and cost effective tool:

- they enable the OFT to identify and address the root causes of market failure,
- they are an effective way of tackling regulatory and other Government restrictions on competition, and
- they allow for a simultaneous examination of competition and consumer protection issues.

3.1.3 CC market investigations

Market investigations are conducted by the CC on reference from the OFT, sectoral regulators or, exceptionally, a Minister. Their purpose is to examine whether features of a market (including structure or behaviour of suppliers or customers) prevent, restrict or distort competition and so have an adverse effect on competition (AEC). If so, the CC must consider appropriate remedies either to be imposed by itself or by others. It can also recommend changes to the regulatory or legislative framework affecting a market.6

Market investigations provide a structured, transparent framework for addressing complex issues in complex markets, and the recent PPI Report is a good example of this process.7 The CC’s remedy powers include the power to order divestment of businesses or assets; an example from outside the financial services sector where such a remedy may be imposed is the still current investigation of BAA Airports.8 The possibility of future divestment is important in the financial services context where one of the short term responses to financial instability has been to permit or encourage consolidation.

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6 See for example the CC’s investigations into personal current account banking services in Northern Ireland, Store Cards, and PPI.
CC market investigations should not be confused with OFT market studies. The OFT is able to make a market investigation reference to the CC when it suspects that a feature or combination of features of a market prevents, restricts or distorts competition. If a reference is made, the CC will conduct a detailed public investigation and reach its own conclusions about the market concerned. The CC has the power to impose remedies which go beyond the outcomes available from an OFT market study.9

3.1.4 Merger control

This section sets out the basics of merger control in the UK.

The OFT has a function to obtain and review information relating to merger situations, and a duty to refer to the CC for further investigation any relevant mergers which it believes have resulted or may be expected to result in a substantial lessening of competition in a UK market. The OFT also has the function of advising the Secretary of State for Trade and Industry (the Secretary of State) on mergers which might fall within the scope of the public interest or the special public interest provisions of EA02. The UK’s submission to the roundtable on Crisis: Role of Competition Policy in Financial Sector Rescue and Restructuring sets out a detailed explanation of how the failing firm defence should be applied during periods of financial distress or economic retrenchment.

Following a merger reference, the CC must decide whether a relevant merger situation has been created; and if so whether the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition within any market or markets in the UK for goods or services. If the CC finds that there is an anticompetitive outcome it shall decide:

- whether action should be taken by it, or by others, to remedy, mitigate or prevent the substantial lessening of competition concerned or any adverse effect that has resulted from, or may be expected to result from, the substantial lessening of competition, and
- what action should be taken and what is to be remedied, mitigated or prevented. It is therefore only the CC that can prohibit a merger (or the Secretary of State in exceptional cases).

The EA02 also permits intervention by the Secretary of State in public interest cases. In these cases, the Secretary of State may take public interest factors other than the OFT’s competition assessment into account in deciding whether to clear, refer or remedy a merger. The EA02 was amended recently to allow the Secretary of State to take financial stability into account when deciding whether to clear or remedy a merger.

Some mergers may cause concern about loss of competition because of an overlap which gives the merged company a significant share of a specific market although it involves only part of that company’s activities. Sometimes the company may resolve the problem by divesting itself of part of its business (known as ‘structural undertakings’); alternatively, in order to counter the concerns that have been raised, it may give a formal commitment about its future conduct (known as ‘behavioural undertakings’). Under the EA02, the OFT (or Secretary of State in public interest or financial stability cases) may accept binding undertakings from a merged business as an alternative to making a reference to the CC.

These provisions can be used only where the OFT (or Secretary of State in public interest or financial stability cases) has concluded that the merger – whether anticipated or completed – should be referred to the CC, and has specified the adverse effect giving rise to the significant lessening of competition. Any undertakings must be for the purpose of remediying or preventing the adverse effects identified.

3.1.5 Consumer policy

The OFT also has the power to enforce consumer protection legislation, to approve and promote voluntary consumer codes of practice that meet the OFT’s core criteria the purpose of which is to safeguard consumers' interests by helping them identify businesses with higher standards of customer care.

The OFT can use the EA02 to seek changes in trader behaviour that contravenes consumer protection legislation such as the Consumer Protection (from Unfair Trading) Regulations, the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs), the Distance Selling Regulations and the Sale of Goods Act 1979.

The Consumer Codes Approval Scheme is a means of approving and promoting voluntary business to consumer codes of practice that meet the OFT’s core criteria and that work well for consumers in practice. Section 8 of the EA02 is the legal basis of this scheme. It aims to safeguard consumers' interests by helping them identify businesses with higher standards of customer care.

The OFT also carries out other consumer protection work including Scambusters.

3.1.6 Competition and consumer advocacy

In addition, the OFT has a broad remit under the EA02 to advise other Government departments (OGDs) where their actions and policies have an effect on competition or consumers.

All new Government policies need to be accompanied by an Impact Assessment, which includes a specific analysis of impacts of the policy on competition. The OFT has previously published guidance to Government on competition principles in areas of public sector activity. These reports can be distinguished from market studies because:

- they are practical guides for Government about how to apply competition principles.
- they do not involve surveys of industry players, and collection of evidence – but simply set out the OFT’s view of how competition can be made to work more effectively in public sector markets.
- because of their more specialist nature they are more likely to be outsourced to economic consultancies.
- they may be joint publications with OGDs.
- they do not trigger an obligation on the part of the Government departments to whom they are addressed.

The CC can, and frequently does, recommend changes to existing laws and regulations in its reports as part of its formal remedies.
3.2 Institutional arrangements

As set out above, the UK has two competition agencies that can consider competition issues in the financial services sector: the OFT and the CC. In addition, the OFT has a competition scrutiny role under special legislation which is discussed from paragraph 47 onwards.

The Financial Services Authority (FSA) is the financial services regulator of the UK and the OFT works closely with it. The FSA does not have powers to conduct competition investigations or to conduct merger reviews. Therefore, the OFT and the CC (where a reference has been made to the CC) are responsible for the application of competition law in the financial services sector and can conduct market studies/market investigations respectively. In addition, the OFT has a role in enforcing consumer law in the financial services sector.

The OFT and CC will interact with the FSA and other key stakeholders in the financial services industry through a number of different mechanisms in order to promote competition - as mentioned above, most notably by engaging with regulators and Government when they are devising new policies and regulations in order to ensure that consideration is given to the impact on competition. The relationship between the OFT, CC and the FSA is examined in further detail below.

3.2.1 The UK competition authorities and the FSA

The interface between competition policy and regulation in financial services is different from that in many other sectors. Typically financial regulation does not directly include competition concerns, unlike in the case of utilities. Rather, it is more concerned with issues of stability and consumer protection. Given the large sums of money that individuals can invest through financial intermediaries, it is not surprising that consumer policy and consumer protection play such an important role in regulation.

The FSA is responsible for regulating financial services with the aim of promoting efficient, orderly and fair markets and helping ensure consumers get a fair deal. The FSA regulates most financial services markets, exchanges and firms. It particular, the FSA sets rules/principles on a range of issues crucial to the functioning of the financial services market such as on information disclosure, capital requirements and market abuse. It sets the standards which firms must meet and it can take action if these standards are not met.

The FSMA sets out four statutory objectives for the FSA:

- market confidence: maintaining confidence in the financial system;
- public awareness: promoting public understanding of the financial system;
- consumer protection: securing the appropriate degree of protection for consumers; and
- the reduction of financial crime: reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

13 These include the Bank of England and HM Treasury. The OFT also has relationships with the different sectoral regulators.
When discharging its function, the FSA is required to address the conflict between regulation and competition by having regard to "the need to minimise the adverse effects on competition that may arise from our activities and the desirability of facilitating competition between the firms we regulate."\(^{16}\)

In addition, the OFT has a competition scrutiny role under FSMA. FSMA requires the OFT to review the regulatory provisions of investment exchanges and clearing houses that apply to the FSA for recognition status for significantly adverse effects on competition. In addition under section 160 of FSMA the OFT can keep under review the regulating provisions and practices of the FSA for significantly adverse effects on competition.\(^{17}\) If the OFT has concerns it may refer the matter to the CC for further investigation. The OFT also carries out a number of other functions.\(^{18}\)

The OFT has worked closely with the FSA for a number of years so as to ensure that consumers enjoy high levels of welfare in financial services. The 2006 OFT report "Building Better Regulatory Outcomes, a joint FSA and OFT action plan" also stated:

> "The fact that the FSA and the OFT operate under different pieces of legislation which have differing objectives and detailed provisions makes it inevitable that there will not be universal commonality of approach across all issues. Wherever possible, however, both organisations seek to ensure there is consistency and coherence of regulatory approach."\(^{19}\)

Much of the interaction between the OFT and the FSA is on an informal basis. A joint action plan (JAP) between the OFT and FSA entitled 'Delivering Better Regulatory Outcomes' was formulated in May 2006 and is updated yearly, most recently in May 2008.\(^{20}\)

The JAP is primarily a vehicle to publicly record where FSA and OFT have been and will be working together on different issues, some programmatic and some project. The OFT and FSA have different but complementary powers and statutory objectives.\(^{21}\) However, where OFT and FSA’s interests overlap, the two authorities work together.

Collaboration between the FSA and OFT on a formal and informal basis (for example through regular meetings, exchange of information, joint industry meetings) has achieved more positive outcomes than if the two institutions had worked in isolation. Although there are some statutory powers governing the relationship between the OFT and the FSA, experience has shown that in most cases consistent informal working relationships provide the best outcome and the OFT has no plans to change its approach.

The UK competition authorities work closely with the FSA when they are engaged on cases in the financial services sector. All three bodies, the OFT, FSA and CC, have worked together during the investigation into the PPI market.\(^{22}\) The OFT and CC kept in close informal dialogue with the FSA to

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\(^{16}\) [www.fsa.gov.uk/pages/About/Aims/Principles/index.shtml](http://www.fsa.gov.uk/pages/About/Aims/Principles/index.shtml).

\(^{17}\) Section 303 FSMA. The OFT also has a duty, under s.304, to keep such regulatory provisions, and practices, of recognised bodies under review and to refer these matters to the CC if appropriate.

\(^{18}\) More information about the work of the OFT's FSMA team is available at: [www.oft.gov.uk/ofat_work/markets/services/Financial-services/](http://www.oft.gov.uk/ofat_work/markets/services/Financial-services/).


\(^{21}\) The FSA does have a second tier competition objective; or rather their principles of good regulation include facilitating competition and maintaining the competitive position of the UK. However, OFT’s key objective is to make markets work well for consumers and competition sits at the heart of this.

minimise the burden on business (for example through avoiding the authorities seeking similar data from parties in different ways) and to ensure that they understood how the FSA viewed various aspects of the market. Close cooperation between the CC and the FSA was an important way of ensuring that remedies imposed by the CC were consistent with FSA rules and were implemented in an appropriate way which minimised burdens on both business and regulators. Similarly close liaison was achieved during the CC’s consideration of the mergers of the London Stock Exchange with Deutsche Börse and Euronext in 2005.

3.2.2 The UK competition authorities and Government

For competition advocacy and market studies the OFT is reliant on developing good relationships with other Government departments in order to acquire knowledge and information about markets. It is important that the OFT demonstrates the benefits, both long and short term, of other Government departments working with it and vice versa to secure markets that work well for consumers.

When working with other departments and organisations there are legal and practical impediments to sharing information and market analysis. Part 9 of the EA02 places restrictions on the ability of the OFT to disclose information which it receives, in order to protect the interests of those to whom it relates. Disclosure of sensitive information is permitted by Part 9, subject to certain conditions being met and consideration having been given to certain matters. On competition advocacy issues there is very little legal or practical impediment to the sharing of information between competition agencies and financial regulators.

In the course of their merger investigations and market studies and investigations, the UK competition authorities work with relevant Government departments to ensure that they are fully familiar with the regulatory environment in which the industries they investigate operate.

In addition, the EA02 includes as part of the competition authorities' remedial framework to make recommendations to others to take action to remedy the competition problems that have been identified. In some cases legal regulations may inhibit entry or market outcomes (for example, planning or certification requirements). In such cases, it may be necessary for the competition authority to recommend modifications of these requirements to the Government or other controlling body to address the problems found. For example, in a regulated sector steps to address competition issues could include recommending modification to licence conditions. It is for the Government or other person to whom the recommendation is addressed to decide whether to act on the recommendation and the OFT and CC will consult the relevant body before making the recommendation. In general, the CC will only use recommendations in merger inquiries and market investigations where it lacks the jurisdiction to impose an effective remedy in its own right.

Strong and regular interaction between the institutions is the best mechanism for ensuring competition agencies engage in coordinated competition advocacy. However, legal and Government requirements strengthen this relationship.

23 The OFT is also reliant on industry and other stakeholders for information. For CA98 cases the OFT has the power to compel undertakings to supply information.

24 This could be the OFT or the CC depending on the individual case.

25 These problems would be a significant lessening of competition in a merger context, or adverse effect on competition identified in market investigation (or the resultant customer detriment in either case).

26 See the Payments Protection Insurance (2009) where the CC made a recommendation to the FSA to use information that would be provided to it pursuant to the CC’s remedies in order to populate a comparison website.
3.2.3 UK competition authorities’ work with international agencies

Working with international partners is key not just to ensuring that competition agencies’ responses to the crisis and recession build on best practice and are coordinated, but more so that long-term business investment can be based on a consistent international approach.\(^{27}\)

The OFT and CC engage with international partners through international networks, such as the European Competition Network (ECN), OECD Competition Committee and International Competition Network (ICN). Engagement with international partners is critical in allowing the authorities to learn from their peers, inform their own thinking on approaches to enforcement and advocacy tools during the recession and to assist in shaping a consistent international approach. By way of example, a presentation given by the OFT’s CEO John to the ICN on *Competition advocacy in an economic downturn*,\(^{28}\) which brought together competition agencies from over 20 countries, has also been helpful in contributing to agencies’ thinking in how to maximise the effectiveness of their advocacy efforts during an economic downturn.

Continued dialogue with other agencies in which problems are shared, issues are discussed and possible positions and solutions are formulated will become increasingly important in formulating a response to the crisis and recession.

4. Possible changes to the financial sector

The credit crunch and subsequent recession are likely to have substantial effects in the medium and long run. Forecasting what these effects will be is extremely difficult, not least because there is ongoing instability in the financial markets at the current time. However, it is possible to propose a number of possible issues that might arise in the future. The three main changes are likely to be:

- fewer players in financial markets,
- more nationalised players, and
- more mergers as the recession causes firms to fail.

These changes in market structure are likely to have an impact on the type of competition issues that arise. The UK’s submission to the roundtable *Real economy: Challenges for competition policy in periods of retrenchment* sets out some of the likely impacts that changes in the financial sector will have on competition in the markets within that sector. Because the financial markets are still unstable, this paper restricts itself to making fairly general observations about possible competition challenges that may arise in the medium and long term.

The recession is likely to continue in the medium term and will bring with it a fall in demand. The competitive effects of a reduction in demand is unclear, it may be that firms will compete more vigorously for the smaller market. However falling demand can also lead to increased instances of joint behaviour to try and reduce costs, for example joint research projects.

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Recession usually means that more firms exit a market and it can also increase barriers to entry. Exiting firms tend to be inefficient so over the long term ‘this process of creative destruction leaves a stronger and more efficient supply base, thus driving innovation and productivity growth in the next period of expansion’. As outlined in the UK’s submission to the roundtable Real economy: Challenges for competition policy in periods of retrenchment, this increase in the number of firms exiting the market may have an impact on the application of merger control.

A likely side effect of the financial crisis is that financial institutions, and banks in particular, will change their behaviour. At a time when trading conditions are more challenging, firms can become more conservative in their behaviour; for example banks may issue fewer mortgages. This will have a direct impact on some consumers who will be unable to renew their mortgage and so will be forced to make alternative housing arrangements. The recent OFT market study on sale and rent back is a good illustration of the way the OFT’s tools can be used to address a topical issue in a timely and proportionate manner.

The financial crisis and recession is likely to create more cases of market failure that competition authorities will have to deal with over the medium and long term.

Financial services and credit markets are extremely important for consumers and society at large. Vulnerable consumers may be at particular risk over the medium and long term. The recession may also create more vulnerable consumers raising the possibility that the UK authorities will have to deal with more, and perhaps more diverse cases of, consumer detriment as a result of market failure.

We now explain how changes in the financial sector may affect the UK authorities’ rules and institutional arrangements.

5. How financial sector changes may affect the UK authorities’ rules and institutional arrangements

5.1 Competition tools and processes

5.1.1 Competition Act 1998 investigations

The medium and long run changes in the financial sector are likely to create more market failures. The CA98 can be applied equally to state owned and privately owned companies and the OFT will remain vigilant in its enforcement of the CA98. However, because CA98 investigations deal purely with anti-competitive behaviour (anti-competitive agreements, concerted practices and abuses of a dominant position), more reliance may be placed on other tools available to the OFT in the future in order to address the type of market failures outlined above that may arise in the medium or long term.

5.1.2 OFT market studies

Paragraphs 20 to 23 set out a brief explanation of the OFT’s market studies tool. Market studies are extremely well placed to address market failures by recommending ways to improve the market outcome for consumers. Financial markets are an extremely important part of the economy and have an enormous potential impact on consumers.

Market studies are an extremely useful and flexible tool that are sufficiently versatile to deal with most market failures based on the current situation.

5.1.3 CC market investigations

Paragraphs 24 and 25 set out a brief explanation of the CC’s market investigations. These provide a robust and transparent framework for examining complex competition and consumer detriment issues of the kind common in the financial services and include the power to order divestments. CC market investigations arise as a result of OFT market studies.

5.1.4 Merger control

It is likely that in the medium term the recession will mean the UK authorities will need to deal with more failing-firm mergers as financial markets consolidate further. To this end the OFT recently restated its position regarding these situations, and the OFT and CC are about to publish joint merger guidelines. The UK submission to the roundtable Crisis: Role of Competition Policy in Financial Sector Rescue and Restructuring sets out the UK’s position on the application of merger control during a period of financial turbulence. While recognising that financial markets possess a particular significance in relation to the wider economy the OFT and CC do not believe that financial markets should be thought of as special for the purposes of competition policy. There is no reason why UK merger control would need to be changed in the medium or long term.

5.1.5 Consumer policy

While the OFT strongly believes that competition remains the best way of delivering optimal outcomes for consumers and businesses it accepts that the market does not always offer sufficient protection to consumers. It is likely that over the medium and long term the OFT will have to work more closely with consumer bodies such as Citizens Advice, Consumer Focus and Which? to provide a combination of protection and empowerment that allows consumers to make the best choices for them while at the same time ensuring vulnerable consumers are not left behind.

5.1.6 Competition advocacy

The recession may mean support for competition falls as the short-run costs are seen to outweigh the long-run benefits. This suggests a possible need for an increased advocacy role to ensure competition, and in particular the benefits of competition, remains on the agenda. The importance of competition advocacy is discussed elsewhere in this paper (see paragraphs 37 to 38 and 77 to 78)


32 Citizens Advice is a charity which provides free information and advice about legal, money and other problems from over 3,200 locations. More information is available at: www.citizensadvice.org.uk.

33 Consumer Focus is the statutory consumer advocacy organisation for consumers in England, Wales, Scotland, and, for postal services, Northern Ireland. More information is available at: www.consumerfocus.org.uk.

34 Which? is an organisation that focuses on consumer issues. Their work includes reviewing products or providing advice. More information is available at: www.which.co.uk.

Increased state ownership may mean that the application of competition policy may be more politically sensitive in the medium and long-term which suggests that there may also be a need for enhanced engagement with Government and effective competition advocacy in the future.

5.2 Institutional arrangements

In the current economic climate there is likely to be a growing number of rules and regulations and it is important that the competition considerations are considered fully when new rules or regulations are proposed or existing rules or regulations are being modified. In a financial crisis it is easy for a government or regulator to overlook competition considerations in order to pursue their central objective of restoring confidence and security in financial markets. Through competition advocacy, competition authorities can attempt to redress this balance and make sure competition considerations are taken into account. They can do this by:

- working with Government and regulators when they are formulating regulation, highlighting areas where there may be competition concerns. The use of competition impact assessments\(^{36}\) for all new policies and regulations is a helpful way of making sure regulators take into account competition considerations. As one of the competition authorities in the UK the OFT is responsible for providing advice on the competition impact assessments and making sure that these are carried out in accordance with the established guidance.

- creating frameworks or guidance for regulatory authorities so that they might apply these frameworks when designing regulation.

- working on an ad-hoc basis with sectoral regulators to identify existing regulation that may be having a detrimental impact on competition and ultimately consumers.

- carrying out market studies and investigations on financial markets and financial products. It is possible that regulation in sectors could be shaped to a degree by market studies or investigations carried out by the authorities.

While it may be the case that there will be an increased role for competition advocacy, particularly over the medium-term as Government and regulators seek to restore confidence in the financial markets the UK competition authorities do not believe that any additional tools or processes are required to ensure that competition remains on the agenda.

Because of the substantial impact financial markets have on consumers and the economy in general, it is important that these markets remain as competitive as possible to avoid the potential for abuse and to ensure that the benefits are passed on to consumers. This means that there must be effective coordination and interaction between competition authorities and regulators when designing regulation. The methods outlined above are a good way of making sure there is coordination between both types of regulators. If any competition concerns do arise the UK authorities can use their existing powers to address the problems.

\(^{36}\) Policy makers are required to carry out a Competition Assessment as part of their Regulatory Impact Assessments, that is, cost benefit analysis. For more information see: www.oft.gov.uk/news/press/2002/08-02
6. **How can competition policy seek to improve competitive conditions in the financial sector?**

As outlined in the UK submission to the roundtable *Principles: Financial sector conditions and competition policy*, the UK competition authorities’ general position is that, regardless of the type of market, competition remains the best mechanism for delivering optimal outcomes (for both consumers and business). Effective competition can provide greater choice and drive efficiency, productivity and innovation. In the absence of definitive evidence of the trade-off between competition and financial stability, the general position applies in financial services markets.

However, it is important that there is sufficient flexibility in competition law to ensure that when market shocks arise wider policy interests can be accommodated. Although this flexibility is important the retention of robust competition policy during a downturn is vital so as not to cause harm in the longer term when economic conditions improve.

The current financial crisis had led to a recession in the UK and this brings with it a fall in demand. Once the recession has passed it is likely that the market structure will have changed as a result of firms exiting the market and consolidation between firms. Any changes in market structure which reduce competition may lead to a reduction in consumer welfare. It is vital that the UK competition authorities have sufficient tools to deal with problems that arise.

These tools can be used to help improve the competitive conditions in all markets, including financial markets, and there is no need for them to be changed as a result of recent market events.

Over the medium and long term it is important that UK competition policy is suitably flexible. By their nature CA98 investigations are fairly inflexible concerning only anti-competitive conduct prohibited by law. In contrast, the market studies and MIR tools are flexible instruments which can be used to address market failures rather than just considering anti-competitive conduct. The scope and duration of a market study can be adapted to the facts and circumstances of the market problem.

Recent OFT and CC work in the financial sector shows how competitive conditions can be improved using the available policy tools to correct market failures and so increase consumer welfare. For example, the OFT's Personal Current Accounts market study, which was published in July 2008, found that consumers focused on more visible fees charged on current accounts rather than less visible fees which make up the bulk of banks' revenues. The OFT found three areas of the market where improvements would be likely to deliver significant benefits to consumers and the wider economy: increased transparency, increased consumer knowledge and making the switching process easier. Rather than make recommendations for remedies in the market study the OFT consulted with the banking industry, consumer groups and interested parties on appropriate next steps. The CC found similar competition problems and imposed similar remedies by Order in its investigation into personal current account banking in Northern Ireland.

Another example of work which sought to improve competition in the financial sector was the OFT's 2007 Small and Medium-sized Enterprise (SME) banking review which found that the undertakings

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38 A consultation paper which sought views on the findings in the report and on potential remedies was published at the same time as the market study. The consultation period ended on 31 October 2008. The paper is available at: www.oft.gov.uk/shared_oft/reports/financial_products/ofl1005con.pdf.


40 In this work the OFT reviewed the undertakings clearing banks gave relating to the supply of banking services to SMEs following the 2002 Competition Commission report on SME banking. This report found
given by clearing banks following the CC’s investigation into SME banking\textsuperscript{41} had helped to increase competition in the market to the extent 'that competition can now be expected to constrain the ability of the four main banks to charge excessive prices'.\textsuperscript{42}

These two examples show that the current UK competition tools and processes work well to improve markets for consumers and there is no reason that they will need to be changed to address issues arising in the medium and long term.

The specific features of the banking sector mean that it is important that the UK competition authorities enforce competition in a way that recognises the realities of the situation they confront. As outlined above, the market studies tool is an extremely flexible method and the flexibility of the OFT as a whole is further increased by its prioritisation principles.\textsuperscript{43} These principles are applied to ensure that the OFT focuses on protecting long-term consumer welfare. As noted in the Principles: Financial sector conditions and competition policy paper, recent market turbulence may result in a shift in focus towards consumer protection themes and work to explore changed consumer attitudes and behaviour, while at the same time maintaining a profile of well targeted interventions to protect competition and consumers.

7. How does state ownership affect competition?

A recession can help improve long-term productivity because it will tend to cause inefficient firms to exit the market. However there is a danger that governments give State aid to inefficient firms and create incentives for wasteful rent-seeking activity.\textsuperscript{44}

Leaving aside arguments over the relative merits of state versus private ownership, we would suggest that the main competition issues relate to situations where state owned (or partially owned) firms are competing alongside private firms.\textsuperscript{45} The question for competition authorities should be whether state ownership confers any competitive advantage that might distort competition in the market, and, if so, what the appropriate response might be. It is worth noting that the European Commission's rules on State aid take no account of whether a firm is state owned or not.

The effect of state ownership on competition and on consumer welfare depends on a number of factors and will be, in part, determined by: the extent of state ownership of firms and in the relevant sector, the way in which the state organises its ownership interest and the extent to which the state chooses to exercise its ownership interest.

\begin{itemize}
\item that the undertakings imposed by the CC had helped to increase competition in the market to the extent 'that competition can now be expected to constrain the ability of the four main banks to charge excessive prices.' The report is available at: www.oft.gov.uk/oft_at_work/markets/services/SME-banking/.
\item Paragraph 1.6, OFT, 2007, SME Banking, Review of the undertakings given by banks following the 2002 Competition Commission report. Available at: www.oft.gov.uk/shared_oft/reports/financial_products/0f937.pdf.
\item There may be other competition concerns raised if there is a state monopoly but these are most likely to occur in markets with natural monopoly in which case regulation would be required whether the firm was state or privately owned.
\end{itemize}
In addition, state ownership might affect competition:

- first, because state firms face cost advantages over private sector firms. This might be, for example, because Government has a lower cost of borrowing;\(^{46}\) or that the regulatory regime between private and public firms differs.\(^{47}\)

- second, because state owned firms may have a wider set of policy objectives beyond maximising profits, leading to different strategic behaviour in the market compared with private firms. For example, with state owned banks there may be a policy imperative to maintain the flow of lending to small businesses.

Any cost advantages and wider policy objectives may cause the state owned firms to act in a way which distorts competition. Given these concerns, it is important that state owned firms, as with private firms, comply with competition law.

Increased state ownership may mean that the application of competition policy may be more politically sensitive in the medium and long-term which suggests there may be a need for increased competition advocacy in the future.

8. Conclusion

This paper has set how that the current financial crisis and recession may impact competition rules, institutions and processes over the medium and long term.

The UK competition authorities’ view is that, even in times of economic turbulence, competition policy has a clear role to play in ensuring that markets work as effectively as possible. There will be occasions when there are other factors which might override the normal application of competition policy. However, such occasions should be the exception rather than the rule. It seems likely that in the future there will be more cases of market failure in financial sector markets. Competition law remains a key tool in dealing with these. There is also likely to be a need for increased use of competition advocacy as the OFT seeks to deliver its mission to make markets work well for consumers.

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46 This might occur because when a firm is state-owned it is considered to have a lower default risk, that is, a similar risk of default to the Government. Because of this lower default risk it is able to access borrowing at a cheaper rate than firms which are not state-owned (and thereby are considered to have a higher risk of default). We do not mean that the state offers loan terms to firms that are better than the terms the firms’ private competitors are able to obtain from the private sector.

47 For example when Northern Rock was taken into public ownership some of the FSA regulatory requirements were waived. For more information see: [www.hm-treasury.gov.uk/press_16_08.htm](http://www.hm-treasury.gov.uk/press_16_08.htm).
UNITED STATES

In the United States, the federal antitrust laws generally apply to financial institutions in the same way as to other economic sectors, although special procedures, described below, apply to the review of bank mergers. This paper first discusses the Department of Justice’s review of the competitive effects of bank mergers in the United States. It then describes the Department’s merger and non-merger antitrust enforcement activity and competition advocacy efforts in the financial sector.

1. Review of Bank Mergers in the United States

1.1 Introduction

Since September 2008, financial markets in the United States and around the world have experienced significant turmoil. In 2008, 25 banks in the United States failed and, as of the end of the third quarter of 2008, 171 banks had been identified as “troubled.” In addition, since the beginning of October 2008, over 20 transactions have been addressed under the emergency provisions of the federal bank statutes that govern the mergers of banks and bank holding companies.3

Despite the current financial situation, more than 7,100 separately insured banking entities operate in the United States. More than 5,900 state and national banks operate as subsidiaries of about 4,900 bank holding companies. These bank holding companies collectively hold more than 98% of all bank assets in the nation and are regulated by the Board of Governors of the Federal Reserve System (Federal Reserve). About 1,200 banks operate independently of holding companies, but most of those are relatively small, each with less than $100 million in assets. While the bank holding companies are regulated by the Federal Reserve, their subsidiary banks, or banks independent of a holding company, may be regulated separately by one of the four federal bank regulatory agencies. Additionally, banks may have either a national or a state charter. National banks are regulated by the Office of the Comptroller of the Currency (OCC). At the state charting level, banks may be divided into two groups. Nearly 900 of the state-chartered banks belong to the Federal Reserve System, and thus are regulated by the same bank regulatory agency that regulates the bank holding companies. However, the great majority of state banks, nearly 4,700 in all, are not members of the Federal Reserve System and are regulated jointly by the state bank regulatory agencies and the Federal Deposit Insurance Corporation (FDIC). In addition to banks, thousands of thrifts and credit unions operate in the United States.

2 12 U.S.C. §§ 1828(c), 1842, and 1849(b).
4 As of June 30, 2008, nearly 1,200 thrifts were operating in the United States. Thrifts originally were chartered as special purpose depository institutions, the primary function of which was to accept deposits and invest them in residential mortgages, thus encouraging home ownership. Similar to banks, thrifts may have either a federal or state charter. As a result of regulatory reform, the thrift industry broadened its functions, particularly in the area of commercial lending. Differences between a thrift and a commercial bank have thus narrowed in recent years, and references to the United States banking industry usually
Antitrust review of bank mergers follows a different review process than that for most other industries in the United States. Bank mergers are subject to concurrent competitive review by either the Federal Reserve, the OCC, the FDIC, or the OTS, and by the U.S. Department of Justice’s Antitrust Division (Department). During the recent financial market turmoil, the Department has worked closely with the federal bank regulators to provide expedited competitive review for emergency banking transactions, and to fashion appropriate remedies.

1.2 U.S. Banking Statutes and Antitrust Review of Banking Applications

Antitrust review of bank mergers in the United States is governed, in part, by various federal bank statutes, such as the Bank Holding Company Act (BHCA),\textsuperscript{6} the Bank Merger Act (BMA),\textsuperscript{7} and the Home Owners Loan Act.\textsuperscript{8} Bank and bank holding company mergers are exempt from the merger review process under the Hart-Scott-Rodino (HSR) Act of 1976.\textsuperscript{9} Instead, banks and bank holding companies must file with their relevant bank regulatory agency applications for approval of their proposed merger transactions. These applications are forwarded to the Department for competitive review.\textsuperscript{10} Authority to approve or deny banking mergers rests with the bank regulatory agencies.

In most bank merger transactions, the bank regulatory agency responsible for the bank merger application is required to seek comments from the Department prior to approving the application. The Department has thirty days from receipt of an agency’s request to review the competitive effects of a proposed merger and must comment formally on the application by issuing a report on the competitive factors.\textsuperscript{11} After agency approval, the merging banks must wait thirty days after the date of approval before consummating the merger transaction.\textsuperscript{12} Antitrust immunity from challenge under Section 7 of the Clayton Act include both traditional banks and thrifts. The Office of Thrift Supervision (OTS) is the federal bank regulatory agency charged with supervising the national thrift industry.

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5 In 1934, the United States Congress created the federal credit union system, made up of not-for-profit, member-owned depository institutions, to promote consumer thrift. Similar to banks, credit unions may have either a federal or state charter. Today, nearly 8,000 credit unions operate in the United States. Mergers of credit unions do not follow the procedures set forth in the federal bank statutes; rather, credit unions are subject to the reporting requirements of the Hart-Scott-Rodino Act that apply to other industries.


7 12 U.S.C. 1828(c).

8 12 U.S.C. 1467a(e)(2).

9 15 U.S.C. § 18. Note that the procedures described here apply only to transactions involving bank depository institutions. The passage of the Gramm-Leach-Bliley Act in 1999 has allowed bank holding companies to own nonbank financial subsidiaries. Mergers of holding companies with both bank subsidiaries and nonbank financial subsidiaries are considered “mixed transactions” under the HSR Act. The nonbank component is subject to the reporting requirements of the HSR Act and its waiting periods. These HSR Act procedures also apply to acquisitions of financial companies (such as investment banks) that do not include a depository institution.

10 As between the Department and the U.S. Federal Trade Commission, the Department has exclusive jurisdiction to review bank mergers and acquisitions. 12 U.S.C. 1828(c), 1849.

11 See J. Robert Kramer II, Antitrust Review in Banking and Defense, Geo. Mason L. Rev., Vol 11, No.1, pg. 115, n. 23. 12 U.S.C. § 1828(c)(4). The Department reviews each proposed transaction and sends one of four competitive factors reports in response: (1) a “not significantly adverse” competitive factors report; (2) a “significantly adverse” letter; (3) a “conditional letter”; or (4) an “advisory report.” The most recent “significantly adverse” letter was sent in 1999.

12 If the proposed transaction does not raise competitive concerns, the post-approval waiting period may be reduced to fifteen days with the concurrence of the Department.
Act accrues if the Department does not file a suit to challenge the transaction within the 30-day post-approval waiting period.\footnote{13} If the Department files suit, consummation of the transaction is automatically stayed until a federal district court conducts a de novo review of the transaction.\footnote{14}

The BHCA governs mergers or acquisitions involving bank holding companies. Bank holding companies seeking approval under the BHCA file applications with the Federal Reserve. The competitive review procedures under the BHCA are similar to those under BMA, although the BHCA technically does not require the Federal Reserve to give the Department prior notification of a pending application, but rather requires only that the Federal Reserve provide to the Department a copy of its approval of the merger transaction. Nevertheless, because antitrust immunity attaches to these transactions after the specified post-approval waiting period, according to a long-standing practice between the agencies, the Federal Reserve follows the same procedures for applications filed under the BHCA as those set forth in the BMA.

Because of the concurrent review of bank mergers by the Department and the bank regulatory agencies, a significant level of inter-agency staff cooperation occurs on an ongoing basis. Initial review of the large number of bank merger applications received annually by the Department\footnote{15} is done through a “screening process.” The screening process is described in detail in the \textit{Bank Merger Competitive Review Screening Guidelines},\footnote{16} jointly issued in 1995 by the Department, the Federal Reserve, and the OCC. The purpose of this screening is to identify proposed mergers that clearly do not have significantly adverse effects on competition and to allow them to proceed quickly. In investigating the competitive effects of both routine and expedited bank transactions, the Department applies the same federal antitrust laws and antitrust analysis that applies to other industries. Both bank and non-bank mergers are subject to competitive review under the Department’s Merger Guidelines. The Department’s competitive analysis is assisted by the availability of public information gathered by the bank regulatory agencies such as the FDIC Summary of Deposit data,\footnote{17} bank call reports,\footnote{18} small business loan origination data collected pursuant to the Community Reinvestment Act,\footnote{19} and Federal Reserve pre-defined geographic banking markets. These data sources allow the Department to evaluate the competitive effects of a merger transaction expeditiously. Because of the availability of this information, the bank merger review process is highly transparent and predictable.

While the Department conducts a separate and independent competitive review, Department staff routinely provides to the bank regulatory agencies updates on our analysis, our conclusions, and the bases for the conclusions, as well as its proposed resolution of any anticompetitive effect. The Department also

\footnotetext[13]{13}{12 U.S.C. §§ 1828(c), 1842, 1849(b).}
\footnotetext[14]{14}{12 U.S.C. §§ 1828(c), 1842(c). The BMA and the BHCA require the appropriate bank regulatory agency to consider the probable competitive effects of proposed mergers and to deny approval for those that threaten competition, unless the probable anticompetitive effects of the transaction are clearly outweighed by the probable effects on the convenience and needs of the community to be served.}
\footnotetext[15]{15}{Antitrust Division Workload Statistics FY 1998-2007 can be found at http://www.usdoj.gov/atr/public/workstats.htm.}
\footnotetext[16]{16}{The Bank Merger Competitive Review Screening Guidelines may be found at http://www.usdoj.gov/atr/public/guidelines/6472.htm.}
\footnotetext[18]{18}{Reports of Condition and Income, known as “call reports,” contain quarterly financial data on the institution. See http://www.fdic.gov/regulations/resources/call/crinst/callinst2008_Dec.html.}
may consult with the bank regulatory agencies on timing and invite the agencies to have a joint meeting with the merging parties to discuss a proposed merger.

1.3 Role of Competitive Review During Financial Industry Crisis

The U.S. framework for the competitive review of bank mergers enables the application of antitrust analysis to transactions involving the merger of financially troubled institutions. The BMA and the BHCA each provide two procedures for expedited competitive review of banking transactions. Under the first procedure, if a transaction is deemed an “emergency,” the Department has ten days to provide a report on the competitive factors of the transaction and the proposed transaction may be consummated five days after the date of approval by the bank regulatory agency. Under the second, if one of the merging institutions is at risk of “probable failure,” the bank regulatory agency may act immediately; in such a case, the transaction may be consummated immediately upon approval by the bank regulatory agency. The bank regulatory agency determines whether a merger transaction involves an “emergency” or a “probable failure” and, therefore, whether it requires expedited competitive review.

Because of the availability of large volumes of information and data from public sources, the bank application screening system, and the announced principles for the competitive review of bank mergers, the Department and the bank regulatory agencies are able to conduct expedited, but effective, competitive reviews of bank merger transactions. These processes have been in place for years and they continue to be employed even when the number of bank transactions are classified as emergencies or probable failures is increasing.

In the recent wave of banking consolidations, most of the transactions, such as the acquisition of Wachovia Corporation by Wells Fargo & Company, involved the merger of the financial holding companies and were approved under the emergency provisions of the BHCA with a five-day post-approval waiting period. The Department received prior notification, conducted an expedited competitive review, and provided comments to the bank regulatory agency prior to approval of the application. Although the emergency provisions of the BHCA have been invoked for numerous transactions during the current economic difficulties, there are also a wide range of transactions for which the banking regulators play a prominent facilitating role, including a financing role, involving weak banks. For example, the recent acquisition of National City Corporation by PNC Financial Services Group Inc. did not implicate the expedited review procedures. In connection with that acquisition, the Department, along with the Federal Reserve, imposed a significant remedy: the divestiture of 61 local bank offices with deposits totaling $4.1 billion.

All parties involved in the banking industry benefit from the transparency of the competitive review process, the availability of reliable public information, and the close working relationship between the

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21 The term “emergency” appears in the BMA and the BHCA but is not defined. Id.
22 Id.
23 The term “probable failure” appears in the BMA and the BHCA but is not defined. Id.
24 Id.
25 Id.
26 For those transactions that have a non-bank portion subject to the reporting requirements of the HSR Act, the Department also received and reviewed the HSR notifications.
Department and the bank regulatory agencies. As a result of these factors, antitrust review of U.S. bank mergers continues to be relevant and effective even in times of financial industry crisis.

2. Antitrust Enforcement and Advocacy Related to the Financial Markets

During the past decade, the Department has taken numerous antitrust enforcement actions in financial markets. As a general matter, the Department approaches these matters and issues as it would act in other sectors of the economy. However, certain issues recur frequently in antitrust analysis of financial markets, including network effects, two-sided markets, and a heightened potential for vertical foreclosure. The Department’s efforts have included investigations of potential anticompetitive effects of both proposed transactions and participant conduct, as well as dialogue and coordination with other federal agencies charged with regulating financial markets. Some of the more notable examples of the Department’s enforcement activities and advocacy with other agencies are described below.

2.1 Recurring issues in the antitrust analysis of financial markets

Financial markets often exhibit strong network effects. One example is the tendency of trading in any particular financial instrument to become concentrated on a single exchange. The more traders that trade on a particular exchange, the less costly it is to trade on that exchange, as search costs are reduced and increased competition for trades reduces prices. Such network effects have been overcome in some financial markets where regulatory policy has facilitated competition among exchanges. Consequently, network effects need not pose an insurmountable barrier to competition. In some instances parties have argued that network effects are so strong that a market presents a ‘natural monopoly’ and that the proper policy is to regulate the monopolist firm, rather than to protect competition by, for example, price and access regulation. The Department generally has not found these arguments persuasive.

Financial markets often are two-sided, with intermediaries serving two distinct user groups that need each other. (A common example is credit card networks, which serve both issuing banks (and through them, consumers) and merchants.) It is not uncommon for a particular transaction or conduct to affect the market on the one side adversely but to have beneficial effects in the other market. These issues have arisen during the Department’s review of mergers between financial exchanges, for example, which bring buyers and sellers together to provide each with information and execution services. For example, in reviewing First Data Corporation’s acquisition of Concord EFS, Inc., a PIN debit competitor, the Department determined that the potential adverse effects on merchants, in the form of higher interchange fees, outweighed the benefits the parties claimed would result from the combined firm’s greater scale, including pricing and innovation benefits. Accordingly, the Department obtained a court order requiring an appropriate divestiture.

Another recurring issue in the Department’s work concerning financial markets is vertical integration. Vertical issues have been a central part of the Department’s analysis of futures exchanges and clearinghouses, for example, including the Chicago Mercantile Exchange’s (CME) acquisition of the Chicago Board of Trade (CBOT). Common ownership of an exchange and a clearinghouse can have the effect of amplifying network effects and making it more difficult for potential exchange competitors to enter the market. The Department has addressed this concern recently in a comment we submitted to the Treasury Department, discussed below.

Finally, the issue of transparency is often more important in financial markets than in some others. For example, the widespread dissemination of quote and trade information is necessary for financial markets to function efficiently. For this reason the securities laws of the United States, such as the Securities Act of 1933, 15 U.S.C. §§ 77a et seq, ensure that investors in regulated securities will have access to certain fundamental information before making investment decisions. Consistent with these goals, the Department has sought to promote transparency and to limit unilateral and collective action that would have the effect of inhibiting transparency, for example through the advocacy and enforcement efforts described below.

The Department frequently communicates and coordinates with financial regulatory agencies, such as the Securities and Exchange Commission (SEC), the Commodities and Futures Trading Commission (CFTC), and the Federal Reserve (FED). In the course of its investigations, the Department routinely seeks and obtains waivers to inform regulatory agencies of matters within their purview, share statutorily protected information with other regulatory agencies, and solicit their views on the matters before the Department.29 Sensitive to regulatory policy objectives, the Department works to harmonize enforcement of the antitrust laws with other financial regulation.

2.2 Enforcement efforts

2.2.1 Thomson-Reuters

In May, 2007, Thomson Corp. and Reuters Group PLC announced plans to merge, combining the second- and third-largest financial data providers in the world. Working closely with the European Commission, the Department investigated the likely effects of the merger in the markets for information used by participants in a variety of financial markets. The Department examined the prospect of vertical integration and the effects the transaction would likely have in two-sided markets, where the parties stood between suppliers and users of different sorts of data.

In February, 2008, the Department filed a complaint30 to block the merger, together with a proposed consent decree that addressed the Department’s competition concerns by requiring the divestiture of assets in three financial data markets: fundamentals data (basic data reflecting public companies’ financial performance); estimates data (aggregate data reflecting analysts’ expectations for the performance of public companies); and aftermarket research reports (comprising analyst research about particular public companies). The decree was entered on June 17, 2008, and the fundamentals divestiture assets were sold to FactSet while the estimates and aftermarket research divestiture assets were sold to Standard & Poor’s.

2.2.2 Spider Options

Prior to 2005, no exchange listed options on the very popular exchange traded fund (ETF) tied to the Standard & Poor’s (S&P) 500 index (Spiders). An exchange traded fund is an investment vehicle traded on stock exchanges, much like stocks. An ETF holds assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets, usually an index, over the course of the trading day. The absence of options on the Spider ETF was unusual, in light of the large volume of trading in Spiders for which Spider options would be an attractive hedge. On several occasions

29 Absent waivers, confidentiality restrictions of the Hart-Scott-Rodino Antitrust Improvements Act and the Antitrust Civil Process Act would prohibit the Department from sharing with another agency information obtained in an investigation.

in the 1990s various parties asked the SEC to address the question of whether index creators have intellectual property rights in their indices that would permit them to limit or proscribe the listing of options on Spiders and similar financial instruments. The SEC declined to address the issue.

In 2004, the Department opened an investigation into the absence of Spider options. Shortly thereafter, in January, 2005, the Options Clearing Corporation decided to act as a guarantor of Spider options for the International Securities Exchange and agreements between S&P and certain options exchanges to maintain the status quo with respect to Spider options were abrogated. Within a few days, every options exchange was listing Spider options, which quickly became one of the most actively traded options of any kind in the market. With the multiple listing of Spider options, the Department was able to close its investigation.

2.2.3 Options

The Options case involved an agreement among the four options exchanges not to list option contracts listed on any other exchange, but for a brief one-day window when the option was first listed for trading. The agreement frustrated a 1990 SEC decision to encourage options trading on multiple exchanges because of the benefits to investors of exchange competition, specifically, narrower spreads. In the course of authorized implementation negotiations, and unbeknownst to the SEC, the exchanges agreed to procedures designed to effectively frustrate the SEC’s policy objectives.

The Department opened an investigation after hearing stories of the “gentleman’s agreement” regarding multiple listing. The Department brought the matter to the attention of the SEC, which also opened an investigation. Soon thereafter, the gentlemen’s agreement broke down, resulting in the widespread multiple listing of almost all equity options.

The Department and SEC shared evidence and collaborated in designing relief. Both agencies eventually and simultaneously reached a settlement with the exchanges, with the Department’s lawsuit and SEC’s action against the exchanges made explicitly interdependent. Through active cooperation on the part of the agencies, the SEC instituted major regulatory changes that substantially reduced the cost to investors to trade equity options. The consent decree accepted by the options exchanges and approved by the court, in addition to precluding any agreement constraining an exchange’s freedom to list options, required structural changes in the markets to eliminate the mechanisms the exchanges used to enforce their agreements.

2.2.4 Nasdaq. U.S. v. Alex Brown & Sons

It involved a quoting convention among Nasdaq dealers which had the effect of maintaining dealer spreads for retail trades in many important Nasdaq stocks at 25 cents a share, or a quarter-point. The quoting convention was an agreement among the dealers on the Nasdaq exchange to quote their bid and asking price for important stocks at quarter-point intervals. Dealers who broke the convention by quoting


33 Nasdaq is an electronic venue for trading stocks, where dealers post prices at which they are willing to buy and sell.
in intervals smaller than a quarter-point (such as one-eighth point) were harassed and boycotted until they changed their quotes to conform to the convention. As a result of this agreement, the difference between the best dealer’s bid price and the lowest asking price (also known as the “spread”) was at least one-quarter of a point. Absent the “convention” many of the stocks would have traded at much smaller spreads, which would have led to decreased dealer profits. Tapes of dealer conversations also revealed hundreds of instances when a few dealers conspired to manipulate trading in particular stocks for brief periods of time. This anticompetitive conduct occurred despite active, intensive regulation by the SEC and ongoing oversight by the National Association of Securities Dealers (NASD) in its quasi-governmental role. The NASD is a self-regulatory organization responsible for regulation of all securities firms that do business with the public and of The NASDAQ Stock Market, Inc. The NASD’s rules and actions are subject to review by the SEC.

The Department was prompted to investigate this matter by the May 1994 publication of an academic research paper on the Nasdaq markets. The study identified unusual quoting behavior and asserted that the only plausible explanation for the pattern was dealer collusion. The Department’s case resulted in a consent decree that, in addition to prohibiting similar conduct in the future, put in place antitrust compliance and monitoring practices that acted to deter any repetition of the conduct. In addition, information gathered by the Department persuaded the SEC that anticompetitive conduct was occurring, leading to enforcement action against the NASD, numerous dealer firms, and individuals for securities law violations. More importantly, the SEC initiated a rulemaking proceeding to change order-handling practices that facilitated the misconduct. The Department filed comments relating to the likely impact of proposed changes on the competitiveness of the market, given the conduct it had uncovered. The rule changes adopted by the SEC dramatically changed the market structure and, combined with the end of the convention, resulted in annual reductions in equity trading costs of tens of billions of dollars.

2.2.5 Salomon & Steinhardt Short Squeeze Investigations

The Department’s Salomon and Steinhardt-Caxton investigations involved conspiracies between dealers and hedge funds to coordinate their trading in specific U.S. Treasury notes in order to limit the supply of those notes in the secondary trading market and the availability of those notes for use in the lending market. Despite the regulation of the markets by both the SEC and the Federal Reserve, both sets of conspirators significantly affected trading in the instruments.

The Department assumed a leading role in the investigations because of its early effort and success at uncovering the conduct. To the extent permitted by confidentiality requirements, the Department shared information obtained from the parties with the SEC and the Federal Reserve and facilitated their investigations, through the U.S. Attorney for the Southern District of New York, of the same conduct. There were particular advantages in pursuing the conduct in question as an antitrust violation. For example, while the conduct raised novel issues under the securities laws, it easily was defined under the antitrust laws as an agreement adversely affecting competition and was thus a more straightforward case than it might have been as a regulatory matter. Also, the antitrust laws permitted remedies that more fully compensated injured parties. In the Salomon matter, pursuant to the asset forfeiture provision of the Clayton Act, $55 million was paid to the U.S. Treasury. The consent decrees entered in these matters resolved the concerns of all the government agencies with interest in the conduct.

2.3 Competition advocacy efforts

2.3.1 Treasury Comment

On January 31, 2008, the Department submitted a comment\(^{35}\) to the Department of the Treasury in furtherance of Treasury’s review of the competitiveness of United States capital markets. The comment was prepared to assist Treasury in its evaluation of the different regulatory structures overseeing securities and futures products, the intermediaries that trade them, and the exchanges on which they are traded. The Department recommended that Treasury carefully review whether the current regulatory structure for interest rate futures transactions could be improved in a manner that would facilitate entry by new exchanges, allowing more vigorous competition. More specifically, the Department stated that the control exercised by futures exchanges over clearing services—both where positions in a futures contract are held ("open interest") and where positions may be treated as fungible or offset with positions held in contracts traded on other exchanges ("margin offsets")—have made it difficult for exchanges to enter and compete in the trading of financial futures contracts. The Department suggested that if greater head-to-head competition for the exchange of futures contracts could develop, greater innovation in exchange systems, lower trading fees, reduced tick size, and tighter spreads, all leading to increased trading volume, would likely follow.

The Department’s position was informed by its previous reviews of mergers of equity exchanges, options exchanges and futures exchanges. In particular, six months prior to submitting its comments to Treasury, the Department had declined to challenge the merger of the Chicago Merchantile Exchange (CME) and the Chicago Board of Trade (CBOT), two of the largest future exchanges in the United States, after an extensive investigation.\(^{36}\) Prior to the merger, while the exchanges operated separately as venues for trading different financial products, the CME’s clearinghouse already cleared all of the trades on both exchanges. By clearing almost all financial futures trades in the United States, CME’s customers received the benefits of network effects in clearing. Specifically, CME was able to recognize offsetting positions futures traders held in specific futures contracts, or offsetting positions in contracts with a high risk correlation, thereby minimizing the trader’s margin obligation, \(i.e.,\) the collateral that the trader had to deposit to cover credit risk. The Department’s determination that the transaction would not have anticompetitive effects was based, in part, on its conclusions that the products offered by CME and those offered by CBOT were not close substitutes and that neither firm was likely to introduce products directly competitive with the other’s established products. However, the Department also concluded that entry into futures markets is difficult, as reflected by various failed efforts by well established exchanges with substantial resources. In the context of the CME/CBOT investigation, the Department did not address the separate issue of whether the regulatory structure could be improved in a manner that would facilitate entry, or whether current regulatory policy may render such entry more difficult than necessary, because of regulatory approvals of the current structure. As described above, those issues were instead addressed in the Department’s comments to Treasury.

2.3.2 NRSRO Comments

In March 1998, the Department filed a comment with the SEC in the context of SEC rule changes, then under consideration, to help ensure that securities ratings were credible and accurate.\(^{37}\) Securities ratings are issued by Nationally Recognized Statistical Ratings Organizations (NRSROs), effectively the only firms that can issue securities ratings for many uses in the United States. The Department urged the


SEC to modify its proposed rules for securities ratings agencies so that new rating agencies could more easily enter the market, thereby increasing competition. For example, one provision in the proposed rules would have required a ratings agency to be recognized as an issuer of credible and reliable ratings by the predominant users of ratings in the United States before being recognized as a NRSRO. The Department was concerned that this provision could protect incumbent firms from additional competition and could prevent well-capitalized firms with reputations for quality financial analysis from entering the market. The Department also recommended that the SEC require ratings agencies, when providing ratings of securities offerings that were not requested by the issuer of the securities, to disclose that fact. The recommendation reflected a concern that certain NRSROs had issued unsolicited ratings to punish issuers for not utilizing their services. The later enactment of the Credit Rating Agency Reform Act of 2006, 15 U.S.C.A. § 78o-7 (2006), included many of the reforms recommended in the Department’s 1998 comment letter.
UNITED STATES

This submission supplements the U.S. paper that reviews bank mergers and antitrust enforcement and advocacy in the financial markets, and discusses selected additional questions raised in the call for papers.

History is full of examples in which past competition policy responses to financial collapse included justifying anticompetitive arrangements, e.g., “soft cartelization” and price-fixing. However, such arrangements, based on “economic emergency” rationales, generally do not redound to the benefit of the economy and, to the contrary, have had the effect of stifling competition and undermining economic dynamism to the detriment of consumers. Competition agencies have a unique role to play in helping to prevent such outcomes in the current crisis. Through the vigilant promotion of competition principles, competition agencies can help stave off these challenges and even turn such tests into opportunities for advocacy and needed reform.

1. **Principles: Financial Sector Conditions and Competition Policy**

1.1 **Definition**

The financial sector consists of businesses primarily engaged in transactions that involve the creation, liquidation, or change in ownership of financial assets (stocks, bonds, and derivatives). These businesses are principally commercial banks, security brokers and dealers, portfolio managers, insurance companies, and exchanges. ¹

These businesses perform functions that are essential to the efficient functioning of the “real economy.” They allow those who have savings and other assets to lend them to those who want to borrow capital. In exchange, these lenders accept a combination of risk and expected return. The need to pay a return to lenders provides borrowers with the incentive to use capital productively. The opportunity to earn a return provides lenders with the incentive to save rather than consume.

1.2 **Unique Features of Financial Markets**

Financial markets have unique features. Transactions occur at distinctively high speed, high volume, and low cost. This permits an entire subsector to be devoted to arbitrage, something which does not exist in the real economy at nearly the same scale and profitability. While the degree of arbitrage in this field is unique, arbitrage is not implicated in the current financial crisis. We identify it here as a unique tool that contributes to the transparency of financial instruments by ensuring that fundamentally identical instruments trade at the same price.

The uniqueness of financial markets that is relevant to this discussion comes not from any special features of financial markets but rather from a unique mix of properties. Asset managers offer lenders a mix of risk and return, but risk is difficult to measure. This means it is difficult for lenders to really know their exposure to risk. Second, all financial assets are ultimately promises to make payments at a later time or after certain events. Asset values therefore depend on information about the ability of a counterparty to

make those payments. Few people have this information. Finally, leverage—borrowing money to increase returns in certain events—is especially prominent in financial markets. This brings an additional set of agents into transactions and also exposes them to risk. Other markets may share some of these individual properties. For example, many goods have properties that are difficult to measure, and concern about the long-term viability of a company is relevant to many decisions outside the financial sector (e.g., when buying a car). However, the combination of these factors in the financial sector makes them unique to this area.

The difficulty in assessing risk and the dependence of asset prices on closely held information makes trust especially important in financial markets. With the possible exception of credence goods like health care, buyers and sellers in other markets for real goods and services do not face quite so much difficulty in evaluating the fundamental quality of the goods and services they are buying. Financial markets have mechanisms to manage these risks, of course, but formal risk management is ultimately a cost. Trust reduces this expense in many ways, not only as a pure substitute for risk management but also by reducing the need to be aware of the possibility of certain events. Unfortunately, the importance of trust and leverage mean that financial markets are subject to sharp adjustments when trust erodes.

1.3 The Benefits of Competition in Financial Markets

These special properties of financial markets do not reduce the role that competition plays in this sector. Competition provides many of the same benefits in financial markets as it does in other markets. Within the financial sector, it encourages businesses to minimize costs and to innovate. Within the overall economy, competition in the financial sector plays its part in ensuring that resources are allocated efficiently across sectors, over time, and across risks (more formally, “states of nature”). A monopolized or poorly performing formal financial sector will have both static and dynamic effects including the misallocation: (i) of resources between the financial and non-financial sectors; (ii) between capital and labor within the real economy; and (iii) of income between savings and consumption, as well as slower than optimal growth.

It is natural that sentiment toward financial market innovation is negative in the current environment. However, it is important to keep this in perspective. Financial market innovation has increased the availability of capital to a wide range of markets in the real economy. Without these innovations, the real economy would have grown more slowly.

1.4 The Limits of Competition Policy

Financial products, like many other products, become better understood through experience. Competition supports this learning process by providing numerous mechanisms for limiting losses and unwinding positions, and encouraging learning and the dissemination of information that ultimately lead to the more efficient allocation of risk and resources. In most circumstances, this process works very well.


However, the current crisis reveals some limits to these mechanisms. For example, the market for credit default swaps (CDS) grew very rapidly. The fact that many participants in a rapidly growing market may not correctly perceive the risks and rewards, or lack sufficient information to make such judgments, is not a problem that competition policy alone can address. Instead, the problems in the CDS market suggest that certain combinations of size, growth and lack of transparency require further investigation by regulatory authorities. These problems also suggest a more general principle that competition authorities and regulators need to pay attention to whether information asymmetries are present in fast growing markets, and must cooperate to identify markets where competition policy alone cannot address certain market imperfections.

2. Crisis: Role of Competition Policy in Financial Sector Rescue and Restructuring

2.1 Competition Law Set Aside

Setting aside competition law during times of crisis has proven unwise. Indeed, doing so is likely contrary to the public interest. The experience of the United States in the Great Depression, in particular the use of rationalization cartels pursuant to the National Industrial Recovery Act, showed that such an approach is more likely to cause further harm to the economy than to help recovery. Competition is central to well-functioning markets. Our experience and that of others indicates that relaxing existing principles of competition law, through such approaches as greater solicitude towards mergers in the financial industry, is unlikely to help solve an economic crisis, whether in the short- or longer-term.

Procedural rules regarding mergers may be altered when necessary to ensure that competition law does not create exclusively procedural obstacles to economic recovery. However, this has not proved necessary in the U.S. system to date. Under U.S. law, the Department of Justice and the Federal Trade Commission must be notified of mergers that meet certain thresholds. After notification, the merging parties must wait up to 30 days before completing their merger, more if the agency reviewing it has concerns about the competitive effects of the merger. Because such rules may prevent rapid mergers necessary to keep a troubled firm operating, flexibility in the timing may be appropriate. The Hart-Scott-Rodino Act provides that flexibility already, however. Nothing in the statute precludes the agencies from allowing a merger to proceed in less than 30 days once they have determined that the merger will not be anticompetitive, and indeed most mergers receive “early termination” in well under 30 days.

2.2 Failing Firm Defense

Under U.S. antitrust law, merging companies may avail themselves of the “failing firm” defense. When absent a merger one of the merging parties would likely fail as a going concern, the merger may be found not to violate Section 7 of the Clayton Act. This defense plays an important role in competition policy by ensuring that merger law does not unnecessarily lead to assets exiting a relevant market. Its application, however, is narrow. Most important, this defense applies only if there is no alternative purchaser that would create a less anticompetitive effect. Relaxation of the requirements of this defense in times of financial trouble would pose the same problems as relaxing competition law more generally. In an economic downturn more firms may be “failing,” making the defense potentially available to a greater

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5 Id.
8 See Merger Guidelines § 5.1.
number of companies. But that does not suggest that the requirement that the merging firm must show there were no other less anticompetitive alternatives is automatically satisfied.

The reason for the greater number of failing firms in times of economic crisis also should be considered. In some instances, firms fail because they are inefficient or because demand for their products or services has declined. In such cases, firms should either exit the market or merge with firms that remain competitive. In other situations, firms may be failing because of inefficiencies in financial markets. In those circumstances, the better course is to address the inefficiency in the financial markets that is creating the underlying problem, rather than altering merger policy as a way of managing the consequences.

3. Real economy: Challenges for competition policy in periods of retrenchment

3.1 Government Bailouts: Competition Policy Response and Economic Effects

The U.S. government’s assistance to the Chrysler Corporation (“Chrysler”) in 1980 was probably the most well-known example of a government bailout in U.S. economic history prior to the automobile industry bailout at the end of last year. Chrysler’s financial troubles largely stemmed from the fact that it did not respond quickly enough to consumers’ demands for smaller, more fuel efficient automobiles. Chrysler, which was on the brink of bankruptcy, received $1.2 billion in federal loan guarantees. G. William Miller, Treasury Secretary at the time of the bailout, stated, “there is a public interest in sustaining [its] jobs and maintaining a strong and competitive national automotive industry.” Lee Iacocca, Chrysler chairman during the bailout, promised that “[f]ederal loan guarantees, import quotas, and a well-defined industrial policy … w[ould] be the key to American corporate success in the years ahead.”

Alfred Dougherty, Jr., Director of the Bureau of Competition at the FTC at the time of the first Chrysler bailout, stated before the U.S. Senate that

[w]here a firm has misperceived, or been unable to satisfy, the consumer’s needs and preferences, little reason should normally exist to preserve the firm through artificial support. Rather, the opposite is generally true. The failure of the firm increases allocative efficiency by removing an inefficient user of economic resources.

Mr. Dougherty went on to state that, “government support for a failing firm should occur, if at all, only where the most compelling social policy considerations militate for the continuing existence of the firm.” As public calls for a more active industrial policy in the U.S. grew in the 1980s, representatives from the FTC continued to advocate against a more interventionist approach. Former chairman of the

9 The drawbacks of a third alternative—government subsidies or “bailouts”—are discussed in the next section.
10 Other examples include the Penn Central Railroad (1970) and the Lockheed Corporation (1971).
13 Statement of Alfred F. Dougherty, Jr., Director, Bureau of Competition, Federal Trade Commission, Before the Committee on Banking, Housing and Urban Affairs, United States Senate, Government Assistance to Chrysler Corporation (October 10, 1979), p.2.
14 Id., p. 4.
FTC, James Miller III, remarked in 1983 that, “active industrial planning policies did not work in this country in the 1930’s … [a]nd they are not the answer for the United States in the 1980s.”

Federal loan guarantees of the type offered to Chrysler in 1980 may have the effect of crowding out private investment, making it more costly for other businesses and consumers to borrow in credit markets, assuming that credit markets are functioning normally and that the economy is at full employment. In addition, had Chrysler been forced into bankruptcy, the resources under their control could have flowed to more efficient automakers or to more efficient firms outside of the automobile industry. Job losses from a Chrysler bankruptcy in 1980 were estimated to be over 720,000. The federal bailout of Chrysler likely saved some fraction of these jobs -- but not all -- in the short run. Subsidizing an individual failing firm within a larger industry, in the form of loans, loan guarantees, or otherwise, has the effect of preventing the movement of resources to more efficient uses and may result in higher prices for consumers.

3.2 Rationalization Cartels: U.S. Experience and Economic Effects

The National Industrial Recovery Act of 1933 (“NIRA”) was passed in response to the industrial decline that took place during the depression of the 1930s. The NIRA allowed for direct price and output controls, which had been illegal under U.S. antitrust laws, by firms organized into trade associations. It was intended that the price and output controls would stabilize prices at profitable levels but not at joint profit-maximizing levels. It is widely believed that the NIRA was anticompetitive and contributed little, if at all, to economic recovery. The NIRA was declared unconstitutional, and therefore illegal, in 1935 but the anticompetitive effects of the Act were felt long after it was no longer in force.

There are very few exceptions to the per se rule against price-fixing in the U.S. Apart from the brief period of the NIRA, industry distress has never been viewed as a legitimate reason for granting a permanent – or even temporary – exemption from the per se rule. Allowing collusion as a policy response to failing firms prevents the movement of both labor and capital to more efficient uses outside of a distressed industry. As a consequence, consumers pay higher prices both for the goods of the distressed industry and for goods produced outside of the distressed industry.

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16 Supra note 10.


19 See, e.g., United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940) (striking down rationalization cartel originally established under the NIRA).
EUROPEAN COMMISSION

Financial Sector Conditions and Competition Policy

The contribution below addresses some of the important questions raised by the OECD: How are financial markets distinct from other types of markets? In what ways might competition policy treat financial institutions and products differently as a result of these differences? Does competition necessarily promote efficiency in financial markets? What failure of competition may have contributed to the crisis in the financial sector? What is the role of competition policy in financial sector rescue and restructuring? Should competition law be set aside in the financial sector during a systemic crisis on public interest or other grounds?

1. 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?

2. 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

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1 In the last few years, securitization, i.e. the bundling of claims on borrowers which are sold directly to investors, has reduced the apparent relative magnitude of bank-based intermediation (in the sense of banks taking deposits to make loans). However, as the unfolding of the crisis confirmed, banks played an important role in the process of securitization and remained largely exposed to the underlying risk, so that a focus on banks in the remainder of this note is still warranted. The shift towards market-based intermediation has in any event been completely reversed recently, as securitization has vanished, except in its most basic forms.
associated with self-fulfilling expectations that withdrawals will take place. The probability that banks will be subject to runs is naturally also linked to their fundamentals, as weak banks are more likely than others to suffer from a breakdown of trust, leading to a run and self-fulfilling expectations. Still, a change in aggregate uncertainty which leads to a larger dispersion of risk while maintaining the expected value constant may also enhance the probability that runs 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 support 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 takes 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.

2 Note that banks are not vulnerable to runs because of excessive competition. A run can even take place on a monopolist bank.

3 Larry Summers already captured this intuition in a well-known thought experiment delivered at the 2000 AEA conference: "Imagine that everyone who has invested USD 10 with me can expect to earn USD 1, assuming that I stay solvent. Suppose that if I go bankrupt, investors who remain lose their whole USD 10 investment, but that an investor who withdraws today neither gains nor loses. What would you do? ... Suppose, first, that my foreign reserves, ability to mobilize resources, and economic strength are so limited that if any investor withdraws I will go bankrupt. It would be a Nash equilibrium (indeed, a Pareto-dominant one) for everyone to remain, but (I expect) not an attainable one. Someone would reason that someone else would decide to be cautious and withdraw, or at least that someone would reason that someone would reason that someone would withdraw, and so forth. ... Now suppose that my fundamental situation were such that everyone would be paid off as long as no more than one-third of the investors chose to withdraw. What would you do then? Again, there are multiple equilibria: everyone should stay if everyone else does, and everyone should pull out if everyone else does, but the more favourable equilibrium seems much more robust. ... I think that this thought experiment captures something real. On the one hand, bank runs or their international analogues do happen. On the other hand, they are not driven by sunspots: their likelihood is driven and determined by the extent of fundamental weaknesses."

4 This is an issue of equilibrium selection in coordination games. If new information arrives which increases aggregate uncertainty (i.e. a larger dispersion of risk, not a lower expected value in the good equilibrium), then panic equilibria can arise without changing anything in terms of the expected value of the fundamentals. Although expected viability of the system is not changed, bad equilibria suddenly become more attractive for individual depositors from the point of view of strategic uncertainty. I.e., payoff uncertainty seems to create strategic uncertainty in some class of coordination games, leading to a higher likelihood of inefficient equilibrium selection.
3. **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. Indeed, while the failure of a company normally tends to favor 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 realization 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.⁵ Note that these kinds of dynamics also imply that actions that ensure the soundness and viability of one bank (micro-prudential measures involving capital requirements for instance) may actually not enhance the viability of other banks or that of the system as a whole, so that micro-prudential measures may conflict with macro-prudential measures.⁶

4. **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). Indeed, 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.

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⁵ The empirical literature shows that leverage behaves pro-cyclically for investment banks and investment banking arms of universal banks. This implies that the leverage does not only return to its original level after a loss has been absorbed, but even falls below it. Allowing for the fact that lower leveraging may be justified by an exogenous shock, this observation is consistent with the view that banks may actually overreact in their adjustment, which reinforces the downward spiral.

⁶ A prudent shedding of exposures from the point of view of a bank in difficulty may be a withdrawal of funds from the point of view of another bank. When a bank faces a credit loss that depletes its capital, a microeconomic prudent course of action is to reduce its overall exposure, including the lending to other banks. As a result, the other banks face a withdrawal of funds and need to find alternative funding or reduce their asset holdings in turn (curtailing lending or selling marketable assets).
It is beyond the scope of this contribution 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. According to the OECD\textsuperscript{7}, the two main causes of the financial crisis are "the overly loose macro policies [that have affected liquidity] and a very poor regulatory framework [that actually contributed to the crisis in important ways]." 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 securitized market-based financial sector would be more resilient to shocks than a bank-based financial sector).

5. 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 enhance risk taking, hoping that positive outcomes will materialize (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. One can cast serious doubts 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. In any event, allowing for the accumulation of rents in banking for the sake of financial stability is a distant second best relative to direct ex ante prudential regulation.\textsuperscript{8}

\textsuperscript{7} See the 2008 OECD Financial Market Trends publication "The Current Financial Crisis: Causes and Policy Issues". Many recommendations covering a broad range of issues are being discussed actively in policy and academic circles, notably by the Financial Stability Forum (FSF), the G30, the Geneva International Centre for Money and Banking (ICMB), the Institute of International Finance (IIF), the Corrigan report of the Counterparty Risk Management Policy Group III (CRMPG) and others. Proposals include (i) the strengthening of prudential oversight of capital, liquidity, and risk management, (ii) the enhancing of transparency and valuation, (iii) changing the role and uses of credit ratings, (iv) strengthening the authorities' responsiveness to risks, and (v) putting in place robust arrangements for dealing with stress in the financial system.

\textsuperscript{8} More recently, the view has been expressed that increased bank competition would effectively lead to more financial stability. As competition erodes market power and leads to lower interest rates charged to borrowers, the latter can repay their loans more easily while moral hazard and adverse selection problems in bank lending are reduced. The moral hazard problem in lending refers to the fact that ex post the borrower is incentivized to invest in a riskier project than initially announced, as the upward potential is to his benefit, while the losses from a worst case outcome are being borne by the lender. The adverse selection problem in lending is the problem that higher loan rates ex ante will scare off the most creditworthy borrowers, retaining merely the risky borrowers.
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 policy consequence is not to use competition policy to remedy this, but to adapt prudential regulation itself. This allows addressing the root of the problem 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.

6. 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.10

EU 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 the support of 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. Indeed, the rescue measures might strengthen the expectation that insurance will be provided in future cases of distress and provide 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. Indeed, 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.

9 Clearly, this presupposes that the banks' owners and depositors can not assess whether the higher returns generated by other banks originate in excessive risk-taking or whether they are simply managed more efficiently. Otherwise, prudent banks would not be benchmarked with them.

10 The restoration of financial stability has both an individual and a systemic dimension. The latter has much to do with the credibility of the government. Expectations about lower future profits become self-fulfilling if there is no certainty that the government will stop downward-spirals that are purely self-fulfilling (and unrelated to the fundamentals of new information). If one expects other market participants not to panic because the government will stop irrational panic in the beginning, then it is rational not to panic. However, if irrational panic can not be expected to be stopped by the government, then it is rational for an individual to panic once it is observed that others panic. That is, if there is a fundamental trust in the government’s ability to prevent a turmoil that overreacts on the factual new information about the state of the economy, then financial market crises are more likely to be limited to the extent given by the information on the actual new losses.
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 subsidized (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 (FI) have become too big to fail (TBTF) or too interconnected to fail (TITF). This of course implies 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 (as established by the Recapitalization Communication) 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 the restructuring costs (aid 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 recalled 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

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11 The idea of bank deleveraging through a partial swap of junior debt into equity may make sense from a state aid control perspective, as it minimizes moral hazard and keeps the state aid to the minimum, but the effects on financial stability are unclear. Hence the need for the different institutions involved to cooperate in these circumstances in order to achieve the appropriate calibration of policy measures.
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 authorized 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: i) to restore long term viability, ii) to limit State aid to the minimum necessary and iii) to 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 a 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.

7. 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 materialize. 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 skeptical about the potential benefit from exhausting economies of scope. Indeed, 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. Thus, a merger can not 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 create FIs that are TBTF or TITF

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

8. 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 for competition distortions and unlevel playing fields.

The lack of a pan-European Special Resolution Regime for banks that would allow for Prompt Corrective Action by the supervisor before technical insolvency would be reached is a particular source of concern. This would allow the bank to stay in business during the restructuring phase, and would allow for a swift and orderly liquidation, in case the bank is no longer viable. In the absence of such a supra-national regime, EU State aid policy, and more in particular 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.
EUROPEAN COMMISSION

The Role of Competition Policy in Financial Sector Rescue and Restructuring

1. Introduction

The global financial crisis has impacted heavily on the EU banking system in many countries. Recent months have seen a general erosion of confidence within the banking system. The pervasive uncertainty about the credit risk of individual financial institutions has dried up the market of interbank lending and has consequently made access to liquidity progressively more difficult for financial institutions across the board, even those that did not engage in unsound business practices and that are fundamentally sound.

The scale and intensity of the crisis in the financial markets and its potential impact on the overall economy of Member States have put governments throughout the EU under huge pressure to provide a wide range of support measures to assist vulnerable financial institutions in order to safeguard the stability of the financial system. A number of mergers in the banking sector have taken place, often with the financial backing of governments by means of a State guarantee or recapitalisation.

In both areas – State aid and merger – the EU has applied strict policies to ensure that the benefits of competition would not be lost as the result of protectionism, beggar thy neighbour policies, or the creation of national champions.

In view of the exceptional circumstances, there have been calls in recent months for the Commission to considerably “relax” or even “suspend” EU disciplines in the area of State aid or merger control, at least as long as the financial crisis lasts. This has never been an option. On the contrary, EU competition policy is not part of the problem, but part of the solution. Abandoning EU competition discipline at this time of crisis would have risked a disintegration of the European Single Market for banking and financial services. Rather than abandoning competition rules at this time of crisis, the Commission has found that these rules have enabled it to support solutions for stabilising European banks, while at the same time guaranteeing the common European interest.

2. State aid measures targeting the financial sector

2.1 General principles

State interventions during the financial crisis aim primarily at ensuring financial stability and to some extent at ensuring the availability of adequate levels of lending to the real economy. In this way such interventions contribute to the achievement of objectives of common interest. However, they are also likely to create distortions of competition, which need to be minimised through the instrument of state aid control.

First, distortions can appear between States where banks are given an undue competitive advantage over banks in other Member States. Access to funding or capital or other forms of support at considerably lower rates than in other Member States may have a substantial impact on the competitive position of a bank in the wider single European market. Excessive aid in one State could also prompt a subsidy race among States and create difficulties for the economies of States that have not introduced similar support
schemes. For example, a coherent and coordinated approach to the remuneration of public funding and capital injections, and to the other conditions attached to recapitalisation was therefore considered indispensable to the preservation of a level playing field between Member States. In fact unilateral and uncoordinated action in this area may also undermine efforts to restore financial stability.

Secondly, distressed or less-performing banks may receive an undue advantage compared to banks which are better-performing if the measures are available to all banks within a State without an appropriate degree of differentiation between beneficiary banks according to their risk profiles. This will distort competition on the market, distort incentives, increase moral hazard and weaken the overall competitiveness of banks.

Thirdly, public schemes which crowd out market-based operations would frustrate the return to normal market functioning. Thus public recapitalisation, in particular its remuneration, should not have the effect of putting banks that do not have recourse to public funding, but seek additional capital on the market, in a significantly less competitive position.

Experience from recent State interventions to recapitalise banks or to provide loan guarantees have illustrated cumulative competitive effects at each of these three levels. Nevertheless, the EU in its communications and case assessment has shown that it is possible to strike a balance between these competition concerns and the objectives of restoring financial stability and ensuring adequate levels of lending to the real economy.

The application of State aid rules has ensured, and continues to ensure, that State support is granted on conditions that are sufficiently favourable to provide beneficiaries with effective access to capital, whilst preserving a level playing field and paving the way for a return to normal market conditions in the longer term. State interventions have accordingly been designed in a way that is proportionate and temporary in the sense that they provide incentives for banks to exit from reliance on State support as soon as market circumstances permit, in order for a competitive and efficient European banking sector to emerge from the crisis.

Finally, the rescue of banks (or more generally the support of banks in difficulty) had so far the effect of protecting the providers of funds (owners and creditors) and managers of banks from the consequences of past (excessive) risk taking and lead to a problem of moral hazard. Indeed, the rescue measures might strengthen the expectation that insurance will be provided in future cases of distress and provide renewed incentive for excessive risk taking. Measures aimed at financial stability should thus also be designed so as to mitigate problems of moral hazard. Restructuring of ailing banks has an important role to play in this respect. Financial restructuring in particular can ensure that incumbent owners, creditors and managers are not subsidized (given their institutional responsibility for the decisions leading to distress).

For many years, the Commission has applied rules to assess State aid to undertakings in difficulties. These rules are set out in the Community guidelines on State aid for rescuing and restructuring firms in difficulty1 (hereinafter 'R&R guidelines'). The R&R guidelines are of general application, including to financial institutions in difficulty. However, in the light of the seriousness of the current crisis in the financial markets and the specific characteristics of the financial sector, restructuring banks in difficulty will become necessary to avoid serious disturbances in the economy of Member States. The Commission has in recent months adopted complementary guidance setting out standards and safeguards for the application of State aid rules in the financial sector. These standards and safeguards have been enshrined in two Commission Communications which specifically deal with the provision of guarantees and

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1 OJ C 244/2 of 1 October 2004.
recapitalisation of financial institutions. The main provisions of these two Communications will be presented in sections 2.2.1 and 2.2.2 below. The Commission is currently finalising additional guidance for the purpose of impaired assets relief schemes.

The approach of the Commission towards the assessment of measures adopted by Member States to provide support to financial institutions in difficulty is based on the general principles underlying the State aid rules of the Treaty, which require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimized as far as possible. Taking due account of the current circumstances, all support measures have to be:

- well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,
- proportionate to the challenge faced, not going beyond what is required to attain this effect, and
- designed in such a way as to minimize negative spill-over effects on competitors, other sectors and other Member States.

The European approach of publishing guidance in the form of a Commission communication has proven to be an adequate tool to coordinate the interventions of the Member States and in particular to set pricing – in cooperation with the ECB - at a common but adequate and effective level.

2.2 Translation of the general principles into policy

Past experience shows that the resolution of a financial crisis generally involves three steps:

2. Stop/prevent runs on financial institutions;
3. Recapitalisation;
4. Clean-up financial institutions' balance sheets by removing toxic assets and underperforming loans and restructuring.

Initially, Member States adopted measures they considered to be most appropriate to deal with the problems they were facing at national level. In doing so they did not always fully take into account the effects their measures had on financial markets in other Member States. As individual Member States were each taking measures to prevent runs on their national banks, there was a risk that this could lead to a "race to the top" for providing deposit insurance and State guarantees. The latter was particularly important to foster the recovery of interbank lending. To mitigate the competition risks linked to uncoordinated public action, the Community adopted in October 2008 a Commission Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis.

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The second step to be taken concerns the recapitalisation of financial institutions. Such recapitalisation is necessary to restore the financial stability and the confidence needed to support lending to the real economy. The Commission adopted in December 2008 its Communication on the recapitalisation of financial institutions. This Communication provides guidance to governments and undertakings under which conditions recapitalisation would be acceptable under State aid rules.

The EU is currently developing a framework to deal with step 3), which will focus on impaired assets. Some Member States have already announced special measures in that respect. There are at least two difficulties involved designing appropriate measures: the isolation and identification of these assets and their valuation. The Japanese experience suggests that this third step will have to be undertaken at some point in order to avoid a prolonged crisis.

In conclusion, in the last months the Commission has tried to react as swiftly as possible to the unprecedented developments in the financial sector. It has provided Member States with a framework that coordinates national measures to combat the crisis and aims to avoid harmful spill-overs. Many EU Member States have implemented State guarantees and recapitalisation schemes. By means of the guidance it has given and by its decisions in concrete cases, the Commission has ensured that the schemes introduced by individual Member States would not unduly favour the beneficiaries to the detriment of their competitors or would aggravate the liquidity problems of financial institutions located in other Member States. These standards and safeguards are briefly discussed below.

2.2.1 Standards and safeguards for State guarantees

The Commission Communication of October 2008 has developed a number of standards and safeguards for a variety of measures, which have to be complied with by governments. The following overview lists the most important standards and safeguards with respect to the most important measure covered by that communication, i.e. State guarantees:

- **Eligibility for a guarantee scheme:** Significant distortions of competition may arise if some market players are excluded from the benefits of the State guarantee scheme. The eligibility criteria for such a scheme must therefore be objective and non-discriminatory.

- **Types of liabilities covered:** As regards guarantees going beyond retail deposits, the selection of the types of liabilities covered should, as much as possible, be targeted at the specific source of the difficulties and restricted to what can be considered necessary to confront the relevant aspects of the current financial crisis. Otherwise they could delay the necessary adjustment process and generate harmful moral hazard.

The drying-up of interbank lending justified guaranteeing wholesale deposits and short and medium-term debt instruments. However, State guarantees should not cover subordinated debt (tier 2 capital), as it would merely tend to safeguard the interests of shareholders and other investors.

- **Temporal scope of the guarantee scheme:** The duration of any guarantee scheme should be limited to the minimum necessary. In practice, the duration of any guarantee scheme is normally limited to six months. Schemes could be prolonged in case of a continuation of the crisis, subject to a regular review.

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• **Appropriate remuneration**: A Member State guaranteeing bank liabilities should take appropriate steps to ensure a significant contribution from the beneficiaries and/or the sector to the cost of the guarantee and, where need arises, the cost of State intervention if the guarantee has to be drawn upon. The exact calculation and composition of such contribution depends on the particular circumstances. In general, the fees charged for the provision of the scheme should come as close as possible to what could be considered a market price reflecting the varying degree of risks and the beneficiaries’ different credit profiles and needs.

• If the guarantee has to be activated, a further private sector contribution could consist in the coverage of at least a considerable part of the outstanding liabilities incurred by the beneficiary (if it continues to exist) or by the sector.

• **Behavioural constraints**: Distortions of competition are to be avoided by an appropriate remuneration as well as by behavioural constraints. Such safeguards should include an adequate combination of some or all of the following elements:
  
  − Ensuring that the beneficiaries (i.e. financial institutions) do not engage in aggressive expansion against the background of a State guarantee to the detriment of competitors not covered by such protection. This can be done by restrictions on commercial conduct (i.e. advertising invoking the guarantee status) or by the prohibition of conduct that would be irreconcilable with the purpose of the guarantee as such as (e.g. share repurchases by beneficiary financial institutions or the issuance of new stock options for management).

  − Appropriate provisions to enforce these behavioural constraints including the sanction of removing the guarantee protection from a beneficiary financial institution in case of non-compliance.

  − In the case a guarantee is drawn upon, the beneficiary has to restructure its business.

2.2.2 **Standards and safeguards for the recapitalisation of financial institutions**

In relation to recapitalisation measures the Commission Communication of December 2008 identifies a set of standards and safeguards. These standards and safeguards include the following:

• **Pricing of recapitalisation**: Closeness of pricing to market prices is the best guarantee to limit competition distortions. Remuneration for State recapitalisations should neither be based on the very low pre-crisis levels, nor at the high current market rates. Instead, remuneration should instead be set at a level that allows banks to avail themselves of such instruments and that thereby favour the restoration of financial stability and the provision of adequate levels of lending to the real economy. Notwithstanding this, a remuneration rate not too distant from current market prices is essential in order to avoid crowding out recapitalisation via the private sector and facilitating the return to normal market conditions.

An overall remuneration needs to adequately factor in the following elements:

  − Current risk profile of each beneficiary;

  − Characteristics of the capital instrument chosen, including its level of subordination; risk and all modalities of payment;

  − Appropriate benchmark risk-free rate of interest.
Particular importance needs to be attached to the risk profile of the beneficiaries. Financially sound banks may be entitled to relatively low rates of entry to any recapitalisation, and correspondingly significantly reduced conditions on public support in the longer term, provided that they accept terms on the redemption or conversion of the instruments so as to retain the temporary nature of the State's involvement, and its objective of restoring financial stability/lending to the economy, and the need to avoid abuse of the funds for wider strategic purposes.

In principle, banks with a higher risk profile should pay more. It may however be necessary, in duly justified cases, to accept lower remuneration in the short term for distressed banks, on the assumption and condition that in the longer term the costs of public intervention in their favour will be reflected in the restructuring necessary to restore viability and to take account of the competitive impact of the support given to them in compensatory measures.

- **Incentives for State capital redemption**: Recapitalisation measures need to contain appropriate incentives for State capital to be redeemed when the market so allows. The simplest way to provide an incentive for banks to look for alternative capital is to require an adequately high remuneration for the State recapitalisation. An add-on to the price determined on the basis of the above criteria will incentivise exit. A pricing structure including features increasing the rate of remuneration over time or mechanisms that encourage private capital raising will reinforce this incentive.

  In certain circumstances a restrictive dividend policy can contribute to ensure the temporary character of State intervention, bearing in mind that it is important to allow for dividend payment where this represents an incentive to provide new private equity.

- **Prevention of undue distortions of competition**: In the same way as for guarantees, safeguards may also be needed in the case of recapitalisations in order to prevent aggressive commercial expansion financed by State aid. Moreover, when Member States use recapitalisation with the objective of financing the real economy, they have to ensure that the aid effectively contributes to this. To that end, in accordance with national regulation, they should attach effective and enforceable national safeguards to recapitalisation which ensure that the injected capital is used to sustain lending to the real economy.

- **Distinction between fundamentally sound and distressed banks**: A distinction should be made between fundamentally sound banks whose difficulties stem only from the current general market conditions and distressed banks facing a risk of insolvency as a result of their particular business model or investment strategy. Indicators for this differentiation should include compliance with regulatory solvency requirements and prospective capital adequacy as certified by the national supervisory authorities as well as the relative size of recapitalisation.

  Notwithstanding the need to ensure financial stability, the use of State capital for a bank that is not fundamentally sound can only be accepted on the condition of either the bank's orderly winding-up or a thorough and far-reaching restructuring, including a change in management and corporate governance where appropriate.

  In line with the principles set out above, the recapitalisation of banks that are not fundamentally sound should be subject to a higher rate of remuneration and stricter behavioural safeguards.

  As set out above, the third step leading to the resolution of the financial crisis, i.e. the clean-up of financial institutions' balance sheets by removing toxic assets and underperforming loans and restructuring
has not been implemented to any significant extent. It is however the intention of the EU to also provide
guidance on the State aid aspects of these type of measures in the near future.

3. **Merger review in the financial sector**

In the context of the financial crisis, rescue mergers between banks as well as nationalisations of
banks by Member States have given rise to new challenges for the application of EU merger control, in
jurisdictional, procedural and substantive respects. The Commission's analysis has however shown, and
experience has confirmed, that, in any event, these challenges are an insufficient ground to relax or
temporarily set aside the rules in place on merger control. On the contrary, the EC Merger Regulation
constitutes an appropriate and sufficiently flexible tool for merger control enforcement also in times of
crises. The overall objective is the application of merger control in a manner that takes into account the
requirements of financial stability for the banking system whilst not allowing the creation of anti-
competitive market structures.

3.1 *Nationalisation and related jurisdictional issues*

From a jurisdictional perspective, nationalisations of financial institutions by Member States are a
new development. As such, the Commission treats nationalisations in a similar way to acquisitions of
companies by private parties. This follows directly from Article 295 of the EC Treaty which provides that
the rules in Member States governing the system of property ownership shall in no way be prejudiced by
the EC Treaty.

It has to be emphasised however that the design or implementation of a nationalisation measure must
respect all Treaty obligations, including those on competition.

Similar to acquisitions of control by private entities, acquisitions by public entities may therefore also
be subject to mandatory notification to the Commission under the Merger Regulation. Whether an
obligation to notify exists will in practice depend on the factual circumstances of the case at issue. The
general rule is that no prior notification is required as long as the financial institutions are held by the state
after the operation, as economic units with an independent power of decision.

In particular for cases where states hold controlling interests in more than one financial institution, it
has to be ascertained, in order to exclude an obligation to notify, that there is no room for coordination
between different state-controlled banks. Factors to be taken into account when assessing the possibilities
of coordination of commercial conduct include the degree of interlocking directorships and the degree of
information sharing between the acquired and acquiring entities. Overlapping directorships should as a rule
be entirely excluded, while mechanisms should be put in place to ensure that, irrespective of how the state
interest is held, commercially sensitive information is not shared among the acquired businesses. Finally,
the acquired banks must be in a position to formulate their business strategy and carry out their day-to day
business, typically ensured by adopting budget and business plans on an autonomous basis. Nationalisations which fulfil the above criteria should not constitute notifiable transactions.

3.2 **Procedural issues**

One of the specific challenges the Commission faces in its review of mergers in times of crises is of a
procedural character. Timing of the review process and the possibilities to consummate a merger are
normally of essence for the merging parties and may be an even more pressing issue in case of rescue
mergers.
The review periods provided for by the Merger Regulation are short and follow a well defined time frame, the purpose being to ensure that the Commission has sufficient time for a thorough examination of the concentration while still allowing for a swift and foreseeable review process for the parties.

As a rule, the Merger Regulation provides for a stand still obligation pending the Commission review, i.e. transactions notifiable under the EC Merger Regulation cannot be implemented before being cleared by the Commission. However, rescue mergers may require rapid and flexible reaction by the Commission in order to enable at least partly the immediate implementation of transactions. If required by the financial situation of the parties involved, the Commission can accommodate the necessity to implement immediately by granting derogations from the stand-still obligation, taking into account the effects of such a measure on the parties directly involved in the transaction, on third parties and the possible effects on the market as such. Complete and partial derogations have been granted on request in a very limited number of cases and have proven sufficient to achieve the goal of maintaining the financial stability of the target during the time required for the merger control process to be completed.

3.3 Substantive issues: the failing firm defence

As a practical matter, there has hitherto been no case brought before the Commission where the merging parties have raised a failing firm defence as a result of the financial crisis, neither in the financial sector nor in the "real economy" sectors. This is largely due to the fact that, with few exceptions, States have not as of yet "allowed" banks to fail and have been in a position to take various policy measures to this end including full nationalisation, recapitalisations and various types of guarantees.

Nevertheless, it cannot be excluded at this stage that a failing firm scenario could arise should such measures not be sufficient or have the intended effects with regard to any particular market or firm. In this respect, when assessing the competition impact of a merger, the Merger Regulation allows the Commission to take into account rapidly evolving market conditions and, where applicable, the failing firm defence.

In order for a failing firm defence to be accepted, three cumulative criteria are especially relevant as set out by the Commission's horizontal merger guidelines: (i) the allegedly failing firm would, in the near future, be forced out of the market because of financial difficulties if not taken over by another undertaking; (ii) there is no less anti-competitive alternative purchase than the notified merger; and (iii) in the absence of a merger, the assets of the failing firm would inevitably exit the market.

The first limb of the test, financial difficulties, can be demonstrated in particular by (potential) bankruptcy. However, it is not required that bankruptcy proceedings or similar restructuring proceedings have been initiated but rather that it is likely that, absent the merger, the company will enter into such proceedings and that it would not remain in the market as a going concern pursuant to such proceedings. Likewise, evidence of acute solvability problems confirmed by a central bank may be sufficient as a clear sign of material financial difficulties.

Any assessment must take into account all relevant factors, including what public measures have been taken to address acute liquidity or other problems, for example the recapitalisation and guarantee measures taken by many Member States' governments. The precise effects of these measures remain to be seen. However, the assumption is that these measures will make it more difficult to make the case that banks are failing. Thus, although state backing does not as such exclude the possibility that banks could be failing, the parties would have to make a strong case that the government measure is not sufficient to save the bank on a permanent basis.

The second limb of the test is that that there is no less anti-competitive solution available. If this is the case, it should be shown that the failing firm has searched for realistic solutions together with other
potentially interested investors on the basis of objective and justifiable criteria enabling a broadest possible number of viable alternative solutions. Such criteria should allow for cross-border solutions where necessary to safeguard unimpeded competition. In view of governments' recapitalisation and guarantee measures adopted so far, also this condition may be difficult to fulfil. In fact, as a result of such measures, one would have to assess whether a rescue merger is at all a necessary course of action.

The third limb of the test as applied in the past essentially concerns the question whether the company in financial difficulties would completely discontinue its business and exit the market in the absence of the merger. It would have to be assessed on a case-by-case basis to what extent this is likely to be the case having regard to the specific characteristics of the banking sector and considering in particular the market structure post-merger and its counterfactual absent the merger.

It must be noted that even if it cannot be shown that each of the three indicative criteria are met, an analysis of what would be the development of the market absent the merger could still lead to the conclusion that a lessening of competition in the market is not a causal effect of the merger. The Commission will thus undertake a thorough prospective analysis of the market conditions and compare scenarios, with and without the proposed transaction and, where necessary, take into account remedies.

4. Conclusion

As set out in this paper the Commission's competition policy has been adequately equipped to deal with the challenges of the crisis in the financial sector. The fundamental principles of State aid and merger policy have provided a sound basis for dealing with the problems that the markets have been facing in these times of turmoil. In the field of State aid the Commission's policy has been focussed on maintaining a level playing field and fighting beggar thy neighbour policies. It has done so on the basis of its existing set of rules on rescue and restructuring aid as recently complemented by specific rules on State guarantees and recapitalisation schemes for financial institutions. In the case of its merger policy there has been no case for setting aside existing policy either. The rules in place allow for an appropriate response to a wide range of issues.
EUROPEAN COMMISSION
Challenges for Competition Policy in Periods of Retrenchment

1. Introduction

The financial crisis that initially affected the banking sector has in turn had an impact on the real economy. A squeeze on credit, falls in house prices and tumbling stock markets are all reinforcing a slump in consumer confidence, consumption and investment. Economic growth has dropped to about 1% in 2008 in the EU down from just below 3% in 2007 and according to the latest economic forecasts real GDP is expected to fall in 2009 by less than 2%, although growth is projected to remain positive in 9 out of the 27 Member States. In 2010 GDP growth is expected to turn moderately positive, to around 0.5%.1

In response to this situation, the EU has launched a European Economic Recovery Plan resting on two key pillars2. The first pillar is a major injection of purchasing power into the economy, to boost demand and stimulate confidence. The second pillar rests on the need to direct short-term action to reinforce Europe's competitiveness in the long term. The Plan sets out a comprehensive programme to direct action to "smart" investment. Smart investment means investing in the right skills for tomorrow's needs; investing in energy efficiency to create jobs and save energy; investing in clean technologies to boost sectors like construction and automobiles in the low-carbon markets of the future; and investing in infrastructure and inter-connection.

This dire economic situation raises also significant challenges for competition policy. First, and most directly, there is a risk that governments may want to go it alone and wage a subsidy race to rescue national companies and jobs. Governments may also be tempted to relax antitrust or merger rules. For instance, they may want to allow a merger with negative effects on competition if it is perceived as necessary to assist a firm in difficulty. They may also want to favour the creation of national champions, despite possible negative impact on consumer welfare, if such firms are perceived as being in a better position to withstand the present economic difficulties.

However, relaxing competition rules, whether in the State aid or merger area, would actually worsen the problem, because it would harm consumers, impede necessary adjustments by maintaining inefficient companies and ultimately delay the recovery. Historical experience provides ample evidence that suspending competition rules, even temporarily, would have important negative consequences: recent research3 shows that, during the 1930's, some measures such as allowing firms to collude if they agreed to raise wages, prevented price adjustment, were counterproductive and may have delayed recovery by several years.

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In this context, the EU competition policy has a robust and comprehensive tool box which allows it to provide a comprehensive response to the challenges to competition policy that the economic crisis will inevitably raise. When implementing its competition policy, the Commission needs to address the following issue: how to ensure an effective and coherent public response to the crisis while at the same time minimizing the risks of distortions of competition.

When doing so, the European Commission has a significant advantage: unlike most jurisdictions, EU competition policy does not only enable the Commission to act firmly against distortions of competition caused by the behaviour of companies. It is also empowered to effectively control the impact of State interventions on competition by ensuring that a State subsidy race does not create disproportionate and unnecessary distortions of competition. The best way to limit job losses and economic damage is indeed to maintain the integrity of Europe’s Single Market through, amongst other things, the application of the EU’s state aid policy. EU State aid policy provides a strong framework to avoid the unilateral adoption of beggar-thy-neighbour policies by an individual Member State that could very well provoke a downward spiral of retaliatory measures.

With this well-established range of tools, the Commission is therefore well-placed to address the competition related problems raised by the economic crisis in a comprehensive and effective way. Some adjustments in order to adapt these instruments to the seriousness and specificities of the crisis have been necessary. However, as explained below, these adaptations have respected the essential principles of the EU competition policy.

In view of the specificities of State aid and merger control, this note will explain in turn how the Commission uses its instruments to tackle the effects of crisis on the real economy.

2. EU State aid control - part of the solution

The existing mechanisms and objectives of EU State aid control were laid down as early as 1957, in the original Treaty of Rome establishing the European Community. The EC Treaty takes into account that, when considering State aid measures, national governments often do not consider possible negative spill-over effects on competition and trade in the internal market. Member States may have incentives to use State aid strategically to promote national economic interests and develop activities on their territory.

Such State aid may distort competition between European undertakings and undermine Europe's Single Market against the common European interest. In particular, the aid granted by a Member State may divert similar activities elsewhere and may be to the detriment of less prosperous Member States. State aid to domestic firms also shifts rents away from foreign firms who lose profits and market shares and may decide as a result to cut employment and reduce investment (including R&D expenditures). Finally, aid with such cross-border effects may trigger reactions by other Member States. Such subsidy race could lead to an excessive amount of aid, at the expense of taxpayers and could seriously damage the internal market.

The EC Treaty thus establishes the principle that State aid which distorts or threatens to distort competition, is prohibited in so far as it affects trade between Member States. However, State aid which contributes to well-defined objectives of common European interest without unduly distorting competition between undertakings and trade between Member States, may be granted.  

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4 Article 87 of the EC Treaty.
Before granting State aid, Member States must obtain the authorization from the Commission. In some cases, they must notify aid measures (whether individual aid to a specific undertakings, or State aid schemes) to the Commission and must await its approval before the aid can actually be granted. For other measures where the Commission is confident that distortions will be rather limited, it has adopted a general block exemption regulation specifying under which conditions such aid is compatible with the Treaty and does not require prior notification. In case aid is granted by Member States without respecting the procedural and substantive rules, the Commission normally requires its full recovery with interests.

2.1 The principles behind EU State aid control: the balancing test

When designing general State aid rules and/or assessing State aid cases, the Commission balances the negative effects on trade and competition in the common market with its positive effects in terms of a contribution to the achievement of well-defined objectives of common interest. Balancing these effects takes into account the impact of the aid on the social welfare of the EU. For that purpose, the Commission has established a "balancing test" which consists of the following questions:

(1) Is the aid measure aimed at a well-defined objective of common interest? (for example, growth, employment, regional cohesion, environment, energy security).

(2) Is the aid well designed to deliver the objective of common interest, that is to say, does the proposed aid address the market failure or other objective?

1. Is State aid an appropriate policy instrument?

2. Is there an incentive effect, namely does the aid change the behaviour of undertakings?

3. Is the aid measure proportionate, namely could the same change in behaviour be obtained with less aid?

(3) Are the distortions of competition and effect on trade limited, so that the overall balance is positive?

The first two questions address the positive effects of a State aid measure, whereas the third question refers to its negative effects on competition and trade and compares the positive and negative effects of the aid.

As regards the first question, the EC Treaty only provides for some exceptions to the general prohibition of State aid. It is thus necessary to first assess whether the objective pursued by the aid is indeed one that can be regarded as being in the common interest, and to assess the acceptability of that objective.

The second step is then to assess whether the aid is properly designed to reach the well-defined objective of common interest. More specifically, even if it addresses a well-defined objective, a particular State aid may not be an appropriate instrument. This would be the case where the State aid fails to deliver the desired objective or where other less distortive instruments achieve the same results. Further, the aid

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must actually induce the recipient to change its behavior in such a way that the objective can be achieved. This condition would not be fulfilled in cases where the aid is not necessary because the beneficiary would achieve the objective even in the absence of aid. Finally, the aid amount should not exceed the amount necessary to achieve the objective.

The last question addresses the negative effects of State aid. Even if it is well-designed to address an objective of common interest, an aid given to a particular undertaking or economic sector may lead to an unacceptable degree of distortion of competition and of trade between Member States. The overall balancing requires not only to trace the effects of the aid on producers and on consumers in the Member States, but also to evaluate their magnitudes and to compare them subsequently. This implies for instance that negative effects of a considerable magnitude need to be offset by a corresponding high level of positive effects.

2.2 Existing State aid rules: a good basis to tackle recessions

The Commission has elaborated detailed rules explaining under what conditions (e.g. eligible costs, intensity of aid, and nature of the beneficiaries) a Member State can grant aid to its undertakings. These rules cover a wide range of categories of aid: for example aid to research, innovation, environmental protection, regional development, development of SMEs, training, employment, risk capital, rescue and restructuring of firms in difficulty.

<table>
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<tr>
<th>Box 1. Overview of most important non-sectoral State aid rules</th>
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<tr>
<td>• Community Guidelines on State aid for environmental protection, Official Journal C 82, 1.4.2008, p. 1</td>
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<tr>
<td>• Community Guidelines on State aid for rescuing and restructuring firms in difficulty, Official Journal C 244, 1.10.2004, p. 2</td>
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<tr>
<td>• Communication from the Commission - Temporary framework for State aid measures to support access to finance in the current financial and economic crisis, Official Journal C 16, 22.1.2009, p. 1</td>
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On the one hand the State aid tool box provides a good basis for Member States' response to the crisis along the lines in the European recovery plan, in particular as regards the focus on smart investments. For instance, the general block exemption regulation allows Member States to provide investment aid to SMEs. It also authorizes support to training, a key element for competitiveness and critically important in times of rising unemployment when new skills need to be developed. In the same vein, support is allowed for R&D projects that would not be undertaken without aid. In addition, the Community guidelines on State aid to promote risk capital facilitate the financing of innovative and fast-growing SMEs and guidelines on State aid for environmental protection allow investment aid for companies to improve their environmental performance and to attain energy saving.

On the other hand, to prevent a harmful State aid race, the EU has strict rules regarding aid for rescue and restructuring for firms in difficulty⁸, limiting the distortion vis-à-vis healthy firms. Thus, aid to rescue or restructure a company can only be granted one time for the same enterprise in order to avoid repeated interventions to keep certain enterprises in the market. Furthermore, restructuring aid is conditional upon implementation of a far-reaching restructuring based on a restructuring plan and seeking to restore long term viability of the company. The beneficiary of the aid must make a real contribution toward the cost of its restructuring. This contribution needs itself to be free of aid. For SMEs, the contribution should amount to at least 25% of the restructuring costs, for medium-sized enterprises 40%, and for large undertakings the percentage shall be established on a case-by-case basis but it should normally be at least 50%. In addition, to limit the distortions of competition, the Commission imposes compensatory measures in the form of divestiture of assets, a reduction in capacity or market presence or a reduction of entry barriers. Rescue aid can also be granted to enable the firm to prepare an orderly liquidation.

The 2008 autumn update of the European Commission's State Aid Scoreboard shows that Member States are increasingly using the possibilities offered by the recently revised EU State aid rules to better target their aid. Member States awarded on average 80% of their aid to horizontal objectives in 2007, compared with around 50% in the mid-1990s with increased spending on R&D and environmental aid.

Thus the State aid rules in place before the recession already provided a good framework to tackle the impact of the financial crisis on the real economy, by targeting smart investments and restricting the use and negative effects of rescue aid. However, the Commission came to the conclusion that these existing rules were not sufficient to address the increasingly acute impact of financial turmoil on the real economy. This is why it adopted a temporary framework addressing this problem.

2.3 New temporary framework: responding to exceptional credit squeeze

As a consequence of the crisis in financial markets, banks have become much more risk averse than in previous years, and as a result much less willing to provide financing. This tightening of credit conditions not only affects weak companies, it can also affects healthy companies which find themselves facing a sudden shortage or even unavailability of private funding, whether loans or risk capital. These heightened perceptions of risk by financial institutions are all the more problematic since these perceptions may become self-fulfilling prophecies: lending dries out because the risk of default is perceived to be higher, which in turn leads to actual bankruptcy of an initially sound undertakings and higher perceptions of risks. It is easy to see how this can snowball with disastrous effects on the real economy, on investments and on employment at the EU level.

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⁸ Defined as a firm which is unable, whether through its own resources or with the funds it is able to obtain from owners or creditors, to stem losses which, without outside intervention by the public authorities, will almost certainly condemn it to going out of business in the short or medium term.
Therefore, in addition to the two communications on State aid to financial institutions in response to the financial crisis, in December 2008 the Commission also adopted a "temporary framework for State aid measures to support access to finance in the current financial and economic crisis" (the "temporary framework") in response to the growing effects of the crisis on the real economy. The new rules target the specificities and the expected temporary nature of credit tightening while fully respecting the general principles and philosophy of the balancing test.

The temporary framework is designed to reduce the negative effects of the financial crisis in the real economy and to that end, pursues three objectives: first, to immediately unblock bank lending and thereby help to provide for continuity in companies' access to finance; Second, to ensure that limited amounts of aid reach the recipients in the most rapid and effective way; Third, to encourage companies to continue investing into a sustainable future, including the development of green products. Its legal basis is Article 87.3.b) of the EC Treaty. This is a rarely invoked provision, which is directly linked to the current financial crisis since it allows the Commission to declare compatible with the common market aid "to remedy a serious disturbance in the economy of a Member State".

The temporary framework provides for a number of new measures that can be applied by Member States for a limited period of time, until the end of 2010, as well as a number of limited temporary derogations from existing State aid rules. It should be noted that the temporary framework applies to all types of firms. However, a significant exception is that it is not applicable to firms that were in difficulties before 1 July 2008.

More specifically, the temporary framework allows Member States to provide the following types of aid:

- A lump sum of aid up to €500,000 per company for the next two years which can cover investments and/or working capital. By introducing this possibility within the temporary framework, the Commission has considered that the potential distortion of competition that it may create will be compensated by the positive effects of the measure in the common market. That is, to facilitate a direct and non-bureaucratic access to finance for companies, in particular SMEs, in a period of financial and economic crisis. In any case, the impact on competition of this instrument will be very limited due to the relatively small amount of aid involved: large companies in difficulty will need additional financing and a restructuring plan.

- Subsidised guarantees for loans at a reduced premium. The guarantee can cover up to 90% of the loan and it may relate to both investments and working capital loans. Member States can grant a reduction of up to 25% of an annual safe-harbour premium to be paid for new guarantees in the case of SMEs and 15% in the case of large companies.

- Aid in the form of subsidised interest rates. In particular, the Commission has recognised that interest rate reductions by Central Banks are not adequately reflected into medium and long term interbank rates. The Temporary Framework therefore allows Member States to grant loans whose interest rate consists of the sum of the central bank overnight rate plus a premium equal to pre-crisis spreads between interbank rates and overnight rates, plus a credit risk premium corresponding to the risk profile of the recipient, as stipulated by the Commission Communication on the revision of the method for setting the reference and discount rates. This allows States to provide loans (whose premia incorporate base rates) that have been constructed on the basis of pre-crisis conditions in credit markets.

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• Subsidised loans for the production of green products (meeting environmental protection standards early or going beyond such standards), with a higher aid intensity (i.e. percentage of the aid with respect to the eligible costs) for SMEs than for large companies.

• A risk capital injection in SMEs of up to € 2.5 million per year (instead of the current €1.5 million) in cases where at least 30% (instead of the current 50%) of the investment cost comes from private investors.

The aid measures that are authorized under the temporary framework are clearly tailored to address difficulties stemming from financial turmoil by lowering the costs of credit (through subsidized interest rates), facilitating access to credit (through subsidized guarantees for loans) or equity (through more general provisions on State aid to risk capital) and relieving smaller firms from financial difficulties (through the € 500,000 lump sum).

Furthermore, in line with the balancing test, the Commission has ensured that the allowed aid measures are proportionate to the objectives and designed to minimize the impact on competition. Thus, the temporary framework favours SMEs, since, under a well-established principle of EU competition policy, aid to SMEs is considered as less distortive of competition at EU level. For instance, SMEs are the only beneficiaries of the temporary framework's provisions concerning risk capital injection. With regard to investment aid and subsidised guarantees, they benefit from higher aid intensity. As to the lump sum of € 500,000, it will clearly be of more importance to relatively small firms than to large ones. This emphasis on SMEs of the temporary framework limits its possible use by Member States to favour national champions, which are by definition very large firms.

In addition, the temporary framework is not applicable to companies that were in difficulties before 1 July 2008. Companies whose difficulties date from before the financial crisis must address their structural problems exclusively on the basis of the general rules regarding rescue and restructuring aid, described above. However, as explained in the introduction, a number of companies may find themselves under stress despite having a sound business plan: the temporary framework can contribute to relieve their temporary financial difficulties. If the aid provided under the framework is not sufficient to address these difficulties, it can mean that the company has more structural problems, in which case the normal rules of rescue and restructuring aid will have to be applied. This set of rules regarding firms in difficulties is precisely devised to ensure that over-protective aid measures devised by Member States would not revitalize structurally failing firms to the detriment of competition and healthier firms.

Finally, as indicated by its title, any effect of the temporary framework will be limited in time since it is only applicable until 31 December 2010.


There is a legitimate expectation that the effects of the economic crisis should be taken into account in full when applying competition rules. However, as noted and explained in the Commission's contribution to Round table 1, this must not imply that competition and in particular merger rules should be relaxed or set aside during a crisis situation in order to support specific undertakings. Rather, a proper application of competition and merger rules will ultimately ensure the protection of consumer welfare. The EU Merger Regulation provides an efficient and flexible tool for this purpose. On the one hand, it provides mechanisms to prevent that Member States, in pursuit of goals incompatible with those of ensuring undistorted competition, unduly interfere with the EU merger control process while at the same time recognising their powers to protect their legitimate interests. On the other hand, it provides an efficient and flexible instrument to scrutinize mergers also in rapidly evolving markets.
3.1 **The Commission's powers to maintain undistorted competition**

The Commission has exclusive jurisdiction under the Merger Regulation to assess the competition impact of mergers with a Community dimension. In recent years, there have nevertheless been attempts made by several Member States to intervene by direct use of State power to prevent or restrict the acquisition of domestic companies by companies from other Member States in cases of mergers of Community dimension. Some of these interventions have involved the direct use of State powers, others have taken more indirect forms. The temptations by some Member States to promote national champions has been particularly articulated in the past few years. It cannot be excluded that this trend will be further reinforced as a result of the recession and the financial crisis.

However the goal of achieving undistorted competition must not be undermined by efforts to create national champions to the detriment of pro-competitive domestic or cross-border mergers. A failure to embrace market access on equal terms for domestic and foreign investors is not sustainable over the longer term. Experience has demonstrated that engineering the creation or protection of "national champions" is not the way to succeed as firms that do not face competitive pressures may have an incentive to reduce output, stop innovating and cut jobs, all at the expense of tax payers.

In Article 21 of the Merger Regulation, the European Commission has at its disposal an effective tool to address such actions by the Member States. This provision has the objective of ensuring the Commission's exclusive jurisdiction under the Merger Regulation to assess the competition impact of mergers with a Community dimension. It provides that the Merger Regulation alone applies to concentrations with a Community dimension and that the Commission has sole jurisdiction to review such concentrations and as a consequence that no Member State shall apply its national legislation on competition to any concentration that has a Community dimension.

Also, the Member States are prevented from circumventing the Commission's exclusive jurisdiction by disguising their pursuit of another supposed public interest. In fact, "Member States may take appropriate measures to protect legitimate interests other than those taken into consideration by this Regulation and compatible with the general principles and other provisions of Community law" (cf. para. 4 of Article 21). Such legitimate interests include but are not limited to public security, plurality of the media and prudential rules. Any other public interest must be communicated to the Commission by the Member State concerned and shall be recognised by the Commission after an assessment of its compatibility with the general principles and other provisions of Community law before the measures referred to above may be taken.

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10 A concentration has a Community dimension where the combined aggregate worldwide turnover of all the undertakings concerned is more than 5 billion euros; and the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than 250 million euros; or in the alternative if the combined aggregate worldwide turnover of all the undertakings concerned is more than 2.5 billion euros; and each of the following three criteria are fulfilled: (i) in each of at least three Member States, the combined aggregate turnover of all the undertakings concerned is more than 100 million euros, (ii) in each the same three Member States the aggregate turnover of each of at least two of the undertakings concerned is more than 25 million euros; and (iii) the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than 100 million euros. Finally, even if the two alternative thresholds above are fulfilled, a concentration is deemed not to have a Community dimension if each of the undertakings concerned achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State. Transactions that do not fulfil these criteria may be reviewable by the EU Member States taking into account their applicable notification thresholds.

11 See detailed explanations in para. 38 below.
Therefore, in a nutshell, Article 21 establishes that the Merger Regulation alone – to the exclusion of other pieces of competition legislation – applies to concentrations with a Community dimension (in the sense of Article 1 of the Merger Regulation), and that the Commission has sole jurisdiction to apply the Regulation. It confirms this exclusivity, by ensuring that Member States do not apply national competition rules, whether dedicated merger control rules or not, to a concentration. Finally, it regulates the intervention by Member States, on different grounds than competition, with regard to concentrations of Community dimension. For this purpose, it provides that, in certain limited circumstances, Member States may intervene in relation to concentrations with a Community dimension, and sets out a procedure whereby the Commission can decide on the legality of such intervention from the point of view of Community law. Any industrial policy at the Member State level which has the objective or effect of favouring national champions to the detriment of internal market principles would not be considered legitimate by the Commission.

Until recently, Article 21 had only occasionally been applied. However, in the last three years, the Commission adopted more decisions under Article 21 than in the previous 15 years since the entry into force of the Merger Regulation. For example, the Commission adopted three Article 21 decisions against decisions by the Spanish Authorities prejudicing the bids over the Spanish energy company Endesa, first by the German energy company EON and afterwards, jointly by ENEL and Acciona. It also opened proceedings in relation to the intervention of Italy concerning the Spanish Abertis' attempts to take over the Italian motorway franchisee Autostrade and in relation to Poland's intervention in the merger between HVB and Unicredito. Also, without formally opening a proceeding, it issued warnings under Article 21 in relation to the Italian Central Bank's treatment of two bids for Italian banks by non-Italian suitors (BBVA/BNL and ABN AMRO/Antoveneta).

These experiences have demonstrated that the legal instrument provided for in Article 21 has proven an efficient tool in fighting protectionism. However, this mechanism is particular to the EU legal order, and may not be easily transposable to other jurisdictions which do not have supra-national enforcement agencies.

3.2 The EC Merger Regulation is a tool that can take into account also rapidly evolving markets

When assessing the competition impact of a merger, the Merger Regulation allows the Commission to take into account rapidly evolving market conditions. In procedural terms, rescue mergers may require rapid reaction by the Commission in order to enable at least partly the immediate implementation of transactions. If appropriate in the particular case, the Commission can exceptionally accommodate this by granting a derogation from the stand-still obligation pending the merger review. In substantive terms, the assessment under the Merger Regulation is flexible enough to take into account a rapidly evolving economic environment and where applicable, the failing firm defence.

The failing firm defence allows the Commission to take into account the financial difficulties of a merging firm and its potential exit from the market when assessing the effects of the merger on competition. Its main principles are fully described in Paper 2 on the role of competition policy in the financial sector. So far, no merging parties have invoked the failing firm defence in any of the merger cases notified to the Commission in the course of the current crisis.

To conclude on this issue, our analysis has shown, and experience has confirmed, that the EC Merger Regulation constitutes an appropriate and sufficiently flexible tool for merger control enforcement also in severe market conditions. The overall objective pursued by the Commission in applying this instrument is to ensure that competitive and well functioning market structures are maintained not only today but also in the medium to long term.
4. Conclusion

The experience of the EU in the State aid and merger field demonstrates the importance of a coordinated approach to State aid and merger control in order to avoid a damaging subsidy race or national industrial policies turned towards the promotion or protection of national champions. Lessons that are valid for the EU and its Member States are equally true for the world economy. This is why a coordinated international approach to these policies would be an essential element in the global fight against this major recession.
BRAZIL

The Role of Competition Policy in Financial Sector Rescue and Restructuring

Brazil was not spared by the consequences of the current global financial crisis. Nonetheless, its effects on the Brazilian financial system were considerably less severe than those observed in other countries. The main problems observed so far have been the reduction of liquidity and the rise in the capital cost, especially for the smaller banks, but there’s no sign of systemic risk and the government hasn't needed to bail out any financial institution.

The solidity and soundness of the Brazilian financial system can be attributed to several measures of prudential regulation adopted since the process of reorganization of the banking sector, which was implemented in the 1990’s. In fact, it’s not wrong to say that in comparison to many countries, the banks in Brazil are subjected to a much stricter and more conservative prudential regulatory regime. Following are some of the measures adopted therein:

1. Expansion of the Central Bank's - Bacen's - powers to implement supervision and to address banks’ compliance with safety and soundness criteria. Among these, the Central Bank was given the power to mandate the capitalization, the transfer of control, the merger, the incorporation or the split-up of a financial institution with liquidity problems;

2. The individual responsibility of managers in the case of problems with a financial institution was extended to the controllers stockholders. If the supervision authorities uncover any type of irregularity, they can prohibit the bank from operating with that particular product/service and they can also restrain indicted administrators from assuming positions of authority or management in financial companies in general;

3. Financial institutions must have their financial demonstrations obligatorily audited by independent auditors licensed by the Securities and Exchange Commission of Brazil – CVM. The auditors must inform the Central Bank whenever problems are identified or whenever the bank denies access to information. In case of insolvency of the financial institution, the auditors have the same responsibilities as the managers and the controller shareholders.

4. In accordance with the principles of the Basel Accord, the Central Bank requires from the banks under its jurisdiction a minimum capital amount in relation to their assets, weighted by the risk level of their portfolio. In Brazil, the banks must maintain a Basel capital ratio (the Base Capital to the Required Referential Equity – PRE ratio) greater than 11%, higher than the ratio recommended by Basel I (8%). According to the Central Bank, the Basel capital ratio of the

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2 Resolution nº. 3.081, issued by Central Bank on 05.29.2003.
Brazilian banks stood at about 17% in 2008, which is higher than the ratio observed in many countries.

5. The financial institutions' exposure in foreign currencies, assets and liabilities subjected to foreign currency variation and gold is restrained by a regulatory limit of 30% of their Base Capital (Patrimônio de Referência – PR);

6. Creation of the Credit Guarantee Fund (FGC), a nonprofit entity which is responsible for managing a protection fund for credit holders against insolvency of financial institutions. The FGC covers up to R$ 60,000 per creditor of multiple, commercial, investment and development banks; credit, finance and investment companies; real estate credit companies; the Federal Savings Bank; mortgage companies, and also other types of special accounts. Since its creation, adherence to the FGC is a binding condition for new institutions to operate. The resources to fund the needs of the National Financial System come from a monthly premium paid by its members, fixed at 0.0125% of the average balance in the accounts insured by the fund. Currently, the funds of the FGC are sufficient to entirely cover the deposits of 99% of the depositors of the National Financial System (SFN), which represent about 40% of the total credits against the financial institutions;

7. In July 2004, the New Credit Risk Center System – SCR – was implemented. The system is an information database on banks’ credit portfolios which is updated monthly with data supplied by financial institutions. Banks report all clients with whom they have a consolidated credit exposure above R$5,000, any write-offs and any collateral associated with the loans. The banks must place the reported credits into one of nine different risk classifications defined by the Central Bank rules. The system made supervision of credit risk more accurate and broad as it allows not only the monitoring of losses already incurred, but also the assessment of future debt risk;

8. All Brazilian banks were required to implement by the end of the year 2007 a risk management department, responsible for preventing and solving IT systems failure, fraud (internal and external), inadequate processes, as well as for human resource issues;

9. All Brazilian banks were required to implement by July 2008 a market risk management department, responsible for evaluating the possibility of losses as a result of variation in the market price of its assets;

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3 The *Global Financial Stability Report*, issued by the IMF brings the Basel Capital Ratio in various countries.

4 Circular nº. 3.488, issued by Central Bank on 08.29.2007.

5 Resolution nº. 2.211, issued by Central Bank on 11.16.1995.

6 Financial institutions operating in Brazil are required to classify credit operations in nine levels—decreasingly from AA to H—according to perceived credit risk of the borrower, guarantor and the nature of the operation. Classification criteria were defined in Bacens’ Resolutions nº 2.682, of 12.21.1999, and nº 2.697, of 2.24.2000.

7 More details about the information that are provided to the SCR are presented in the Annex 1 in the end of this text.
Aside the implementation of measures that focused on strengthening and modernizing the National Financial System, in the last couple of years the Brazilian authorities have also made an effort to improve the competitive environment in the banking industry.

Although many studies about competition in the Brazilian banking industry indicate that the concentration in this market is not exceptionally high if compared to the international standard and that they also reject the hypothesis that banks operate under a cartel model, the authorities judge that the spread in the interest rates and the level of fees practiced by banks in the national market are beyond the competitive level. Despite the financial system structure, some characteristics of the financial services can be pointed as favoring this scenario: asymmetric information, moral hazard and adverse selection, switching costs and bundling. Therefore, the Secretariat of Economic Monitoring – Seae, of the Ministry of Finance, and the Central Bank decided to work together in order to identify measures that could be applied to lessen the anticompetitive aspects of these features.

By the end of 2008, this joint work resulted in some important changes in the financial system normative, especially regarding the financial products’ and services’ information that must be available for consumers, the reduction of switching costs and the fees charges. The main actions taken in this direction are presented below:

Simplification of the procedure for credit portability (Resolution nº 3.401, issued by Bacen on 09.06.2006): the new rules permit that the discharge operation of a renegotiated debt with a bank or leasing company be concluded directly by the financial institutions involved. The costs related in the transfer of funds from one institution to another cannot be charged from the borrower. This reduces the red tape, the paperwork and the transactional and operational costs, some of the hindrances to credit portability usage dissemination. Credit portability is not yet possible for real estate financing and operations involving payroll loans. This will be the object of future studies. The real estate financing portability is particularly complicated, because it involves issues related to the transfer of the chattel mortgage, the incidence of taxes and the notary costs.

Improvement in the cadastre portability (Resolution nº 3.401, issued by Bacen on 09.06.2006): since 2001 the banks are obligated to give their clients information about their relationship history with the institution whenever the client requests it. Since the publication of the new norm, the financial institutions have also had to supply this history information directly to any third party appointed by the client. The information must be supplied in at most fifteen days from the request date, it must be based on at least 12 months immediately previous to that date, and it must comprise data about: the monthly average balance in the current account; the monthly average balance of financial applications and investments in the institution; and the loan, financing and leasing operations contracted by the client, with their respective date of contraction and maturity, amount, and payments.

Prohibition of the prepayment fee (Resolution nº 3.516, issued by Bacen on 12.06.2007): the prepayment fee was a type of "exit fee" that has been commonly inserted by financial institutions in their loan contracts requiring the payment of an additional fee in case the borrower early repays his debt. In addition, procedures were defined which must be followed by banks in case of anticipated amortization or discharge of a credit operation contracted by natural person or small business. According to the norm dispositions, the computation of the present value of the debt for prepayment purposes must: use the interest rate stipulated by the contract if the remaining time to elapse until the end of the contract is inferior or equal to 12 months; use a interest rate equivalent

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8 For example see: (a) OLIVEIRA et alii (2006), Evidências sobre a concentração bancária no Brasil; (b) Nakane (2001), Nakane et alii (2006) e ARAUJO et alii (2005).
to the sum of the spread charged by the bank in the original contract with the Selic rate in vigor at the date of the amortization or discharge request, if the remaining time to elapse until the end of the contract is superior to 12 months. The norm also grants the borrower a grace period of 7 days. If during this period he backs off from the credit operation, the calculus of the present value of the payment must also use the interest rate agreed upon in the contract, despite its period of maturity.

12. Obligatoriness of the income account (Resolution nº 3.402, issued by Bacen on 09.06.2006): the income account is a special kind of current account that must be used to receive salary, income, pension, retirement and similar deposits. Since it is a limited-service account, the client must choose if he wants to use it as his principal account or if he wants to transfer the resources received to another bank. In the second case, the institution where the earnings are credited must arrange that the funds are transferred automatically and costlessly every month to the account specified by the client. The intention of this rule is to reduce the switching costs and to stimulate competition among banks. Normally the bank where the salary, pension or retirement is deposited is not chosen by the beneficiary, so they usually turn it into a traditional account to avoid the switching costs (fees, paperwork, time, etc). Now these clients have more incentive to switch to the bank which offers the best deal. In order to prevent future litigation, the obligatoriness of the income account has a phased schedule to come into force. For private companies who had negotiated their payroll with a bank after September 05, 2006, the obligatoriness of the wage account is valid since April 2nd, 2007. For previously negotiated payrolls, the use of the wage account is mandatory by January 2nd, 2009. In the case of government employees, the obligatoriness of the wage-account will also start from January 2nd 2009 if the public entity has negotiated its payroll before 21 of December 21th 2006. Otherwise, the new rule will take effect only after 2012.

13. Information about the Total Effective Rate (CET) on credit operations (Resolution nº 3.517, issued by Bacen on 12.06.2007): Since this amendment, the financial institutions and the leasing companies must inform their natural person clients the real total cost incurred on a credit operation. The CET must be expressed in an annual percentile rate basis and has to be calculated in accordance with the formula settled by the Central Bank. Its purpose is to make it clear to the client the total cost of a credit or leasing operation, therefore its calculus must include not only the amount to be paid in the form of interest rate, but also the tributes, fees, insurance and all other costs charged from the costumer relative to the operation, even if it’s a service contracted by the creditor institution from third parties.

14. Amendment in the rules of bank fees for individuals (Resolution nº 3.518, issued by Bacen on 12.06.2007): the pricing of banking services is still free in the Brazilian banking industry, although some rules were settled aiming to hamper abuses and ease the price comparison among banks. The new rule disposes that the financial institutions are allowed to charge only the fees agreed by contract with their clients or that are related to services explicitly ordered by them. The services supplied to a natural person are classified in four categories: essential, priority, special and differentiated. Since April 30th, 2008 the services classified as "essential" must be supplied free of costs to those clients that hold a current or saving account. The services classified as

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9 Selic rate is the daily average financing rate for Federal Bonds issued by the Brazilian federal government established at SELIC (Special System for Settlement and Custody). It’s the Central Bank overnight lending rate.

10 The services classified as essential and priority are listed in the annex 2 at the end of the text.
"priority" can't have their price increased more than once in a period of 180 days. Also, the increase of any of the existing fees or the creation of a new one must be published with minimum antecedence of 30 days.

15. Standardization of the nomenclature used by banks (Circular nº 3.371, issued by Bacen on 12.06.2007): in order to reduce the searching costs of the clients, the Central Bank set a standard terminology that all banks must use to identify the services classified as priority, since 30th April, 2008. The new normative also specified the abbreviations that must be used to represent those services in banking statements. The collection of fees related to services not mentioned by the normative needs prior authorization from the Central Bank.

16. Creation of a standard financial services bundle (Resolution nº 3.518 and Circular nº 3.371, issued by Bacen on 12.06.2007): it’s commonplace for the Brazilian banking industry the practice of bundling. In order to reduce searching costs, a standard service package was defined which has to be compulsorily offered by all banks. The standard services bundle was built to cover the needs of the average consumer; however banks are allowed to offer other kinds of bundles to their clients.

17. The debt of values related to bank fees cannot exceed the balance in the clients’ current or saving account. In the case of saving accounts, the fees shall be debited only after the credit of the corresponding period earnings is carried through (Resolution nº 3.518, issued by Bacen on 12.06.2007).

18. As from April 2009, the banks will have to provide to natural clients, every year, an annual statement informing, month by month, all the banking fees that have been charged in their current and/or saving account in the previous year (Resolution nº 3.518, issued by Bacen on 12.06.2007).

19. Disclosure of fees (Resolution nº 3.518, issued by Bacen on 12.06.2007): it's mandatory for all financial institutions to publicize in all their branches, correspondents and internet addresses, at a visible place, the prices of their services to natural person or legal entity. The financial institutions also have to notify the Central Bank, at all moments, of any variations occurring in their fees. The Central Bank publicizes at its internet site monthly updated information about fees charged by all banks.

20. Ombudsman’s Offices (Resolution nº 3.477, issued by Bacen on 07.26.2007): all financial institutions authorized by the Central Bank to operate have to institute an ombudsman office to function as a communication and conflicts resolution channel between the institution and their clients. This office must act with independence, impartiality and transparency and a report on its activities, accompanied by statements from an intern and an extern auditing, has to be delivered to the Central Bank every six months.

In addition to the action implemented in the banking sector, the government also created a Working Group to assess the Brazilian credit card industry. This Working Group, which is composed by the Central Bank, the Secretariat for Economic Monitoring and the Secretariat of Economic Law, has collected and analyzed an extensive set of data about the credit card market in Brazil and it hopes to publicize in the next couple of months it's opinion about the structure and the behavior observed in this market 11. The study will also bring some suggestions for future policies regarding this market.

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11 The Secretariat for Economic Monitoring, of the Ministry of Finance, and the Secretariat of Economic Law, of the Ministry of Justice, composes, with the Administrative Council for Economic Defense –
It’s also important to mention a bill which should be approved in the Congress which proposes the regulation of the credit bureaus in Brazil. An important improvement brought by this bill is the permission for the Brazilian credit bureaus to store positive data about the consumers’ payment history. Currently, all credit bureaus in Brazil consist of “negative file” databases, that is, they track long overdue payments and defaults, but carry no “positive” data. Basically, the bill defines the rights and responsibilities of each player involved in the data levy and about whom that information is levied. The bill demands that the credit bureaus preserve the information about the debts paid up-to-date for at least 5 years. It also determines that the bureaus must previously inform the consumers about storing of personal information on the database as well as ensures the costumer's right to demand, at anytime, the exclusion of their positive information from the credit database.

Parallel to the government efforts, the menace of further restrictive normative and the social pressure exerted through the media has stimulated the financial firms to start a movement towards self-regulation. For example, the Brazilian Federation of Banks – Febraban – issued in September, 2008 a Code of Practices that states the principles that should be followed by its associates when delivering services starting January, 2009. Amongst the subjects embraced by the code are the costumer service in diverse channels (telephone, ATM, internet, etc), the procedures to open and close an account, standards of safety and secrecy of clients’ information, etc. The adhesion to the code is voluntary and up to the moment 15 of the biggest banks have adhered to it. Likewise, the Association of Credit Cards Companies and Services – ABECS also have elaborated a self-regulation Code. In vigor since January, 2009, the Code is an attempt to standardize procedures among the credit card companies, to stimulate the adoption of best practices experiences and to settle the main complaints from consumer protection entities. In addition to the Code of Practices, Febraban has also launched a system named STAR that enables consumers to search online the fees practiced by the major banks.

Since the measures mentioned here were implemented very recently, it’s not yet possible to make sound conclusions about their effect on the competition environment in the Brazilian banking industry. However, this Secretariat believes that this type of initiative is convenient especially in moments of financial stress like the one we are experiencing. In fact, it’s clear that the national regulators' priority in the next months will be related to restoring financial stability and this objective may require incentives for banks to merger or incorporate their competitors. In Brazil, for example, some large operations between banks were announced in the last couple of months. Itaú and Unibanco, two of the largest private banks, announced their merger in November, 2008. Together, they formed the largest bank in the country. Most recently Banco do Brasil, the largest federal bank, announced the acquisition of two state-owned banks (Banco do Piauí and Nossa Caixa) and part of a private bank (Banco Votorantim). Other acquisition operations in the financial sector are expected in the short-run, since some important banks don’t want to loose their market position. Furthermore, in order to solve the liquidity difficulties faced by the smaller

CADE, the Brazilian Competition Policy System. The first two agencies have analytical and investigative functions while the third is the administrative tribunal.


14 The System for Financial Services Fees Disclosure – STAR is can be accessed at http://www.febraban-star.org.br/.
banks, the rules for the obligatory deposit were modified, allowing banks to use the amount they should deposit in a reserve account in the Central Bank to buy the credit portfolio of institutions in trouble.  

Thus, on one hand, because of the current circumstances, structure control policies will become even more controversial than they normally are when it comes to the financial sector. On the other hand, exactly because this market is so important and it will become inevitably more concentrated, it can’t be exempted from competition policy. The competition authorities can assume an important role presenting suggestions of instruments that can be used to drive a competitive behavior among banks.

In this context, we are convinced that the cooperation and coordination of actions among financial regulators and competition agencies is deeply desirable, since it can enhance the effectiveness of the propositions. While competition agencies have the expertise in identifying and assessing anti-competitive conducts, the financial regulators have an incontestable advantage in knowing the specificities of the sector and they also have legal enforcement power to demand information and data from financial firms.

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15 The obligatory deposit is a percentage of the demand deposits that financial institutions must compulsorily deposit in a reserve account in the Central Bank of Brazil. The deposit can be done in currency or in federal bond, on discretion of the monetary authority.
REFERENCES

ARAÚJO, Luiz Alberto D´Ávila, NETO, Paulo de Melo Jorge; e PONCE, David Agustín Salazar (2005): “Competição e concentração entre bancos brasileiros”. in Anais do XXXIII Encontro Nacional de Economia from Associação Nacional dos Centros de Pos-graduação em Economia . ANPEC.


ANNEX 1

1. Details about the new credit risk center system – scr

Table 1 – Information that must be monthly provided by regulated financial institutions

<table>
<thead>
<tr>
<th>Information about borrowers that have liability below R$ 5,000:</th>
<th>Information about borrowers that have liability above R$ 5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information</td>
<td>Consolidated data about:</td>
</tr>
<tr>
<td></td>
<td>- quantity of operations</td>
</tr>
<tr>
<td></td>
<td>- quantity of clients</td>
</tr>
<tr>
<td></td>
<td>- provisioning</td>
</tr>
<tr>
<td></td>
<td>- range of maturity</td>
</tr>
<tr>
<td>Detailing</td>
<td>Each of the data above must be discriminated by:</td>
</tr>
<tr>
<td></td>
<td>- nature of operation (granted for the institution itself, acquired from other institution, etc)</td>
</tr>
<tr>
<td></td>
<td>- type of operation (loan, financing, leasing, etc.)</td>
</tr>
<tr>
<td></td>
<td>- risk rating</td>
</tr>
<tr>
<td></td>
<td>- Range value of the credit operation (5 ranges)</td>
</tr>
<tr>
<td></td>
<td>- type of client (individual vs. companies)</td>
</tr>
<tr>
<td></td>
<td>- type of control (state owned vs. privately held, etc)</td>
</tr>
<tr>
<td></td>
<td>- unique risk characteristics</td>
</tr>
<tr>
<td></td>
<td>- foreign exposure (FX exposure)</td>
</tr>
<tr>
<td></td>
<td>- maturity schedule</td>
</tr>
<tr>
<td></td>
<td>- funding of the operation (earmarked vs. non-earmarked credits)</td>
</tr>
<tr>
<td></td>
<td>- type of guarantee (44 categories)</td>
</tr>
<tr>
<td></td>
<td>- extended term for loan-loss provisioning (yes or no)</td>
</tr>
</tbody>
</table>

Information about borrowers:
- taxpayer ID number;
- zip code
- type of client and control (individual vs. companies, state owned vs. privately held, etc)
- date of initial relationship with the client
- borrowers size (micro, small, medium, corporate)
Information about credit: The following data must be informed individually:
- number that identifies the contract
- nature of operation (granted for the institution itself, acquired from other institution, etc)
- type of operation (loan, financing, leasing, etc.)
- foreign exposure (FX exposure)
- funding of the operation (earmarked vs. non-earmarked credits)
- type of indexer
- date of loan
- date of final payment
- operation risk rating
- Effective Real Rate (CET)
- loan-loss provisioned
- information about previous renegotiations of credit
- information about collateral, guarantees and guarantor

If the total borrowers' liability is between R$ 5,000 and R$ 5 million:

If the total borrowers' liability is above R$ 5 million:

In addition to the information above:
- client risk rating
- amount of lender's reserves
- risk rating provided by independent credit rating agency
- collateral value and date of last collateral evaluation

Information about the status of the credits:
If outstanding
If already matured
If written off

- 12 ranges between 0 and 5,400 days
- 14 ranges from 1 to over 540 days
- 2 ranges (less than 1 year and between 1 and 2 years)

<table>
<thead>
<tr>
<th>Table 2 – Institutions obliged to provide information to the SCR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comercial Banks</td>
</tr>
<tr>
<td>Investment Banks</td>
</tr>
<tr>
<td>Development Banks</td>
</tr>
<tr>
<td>Multiple Banks</td>
</tr>
<tr>
<td>Saving Banks</td>
</tr>
<tr>
<td>Mortgage Companies</td>
</tr>
<tr>
<td>Credit cooperatives with credit portfolio above R$ 2 million</td>
</tr>
<tr>
<td>Leasing Companies</td>
</tr>
<tr>
<td>Consumer finance companies</td>
</tr>
<tr>
<td>Development Agencies</td>
</tr>
<tr>
<td>Savings and loan associations</td>
</tr>
<tr>
<td>Credit card administrators</td>
</tr>
</tbody>
</table>

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Table 3 – Access to the SCR data

<table>
<thead>
<tr>
<th>Who</th>
<th>Central Bank’s officers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Regulated financial institutions (only after written authorization of the borrower)</td>
</tr>
<tr>
<td></td>
<td>Borrowers (only their own data)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Channels</th>
<th>Financial Institutions</th>
<th>Web Service</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Internet</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Batch File</td>
</tr>
<tr>
<td>Borrowers</td>
<td></td>
<td>In person request in any of the BCB’s Central Offices of Attendance to the Public - CAPs (available in 10 cities)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>By mail, sending in the required signed documentation. After verifying the authenticity of the documents, the CAP will send a copy of the report to be delivered to the person by hand.</td>
</tr>
</tbody>
</table>

| Type of report | Detailed report of a borrower’s credit history with certain institution (available for the client or for that specific institution) |
|               | Consolidated report that shows the situation of the borrower with the financial system as a whole (available for the client and all regulated financial institutions) |
ANNEX 2

1. Regulation on financial service supply

Table 1 – Essential Services (must be offered with no costs to the clients)

<table>
<thead>
<tr>
<th>Current account for demand deposits:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) banking card to access and manage the resources disposable at the current account;</td>
</tr>
<tr>
<td>b) replacement of banking card (unless in cases of loss, theft, damage because of misuse, etc);</td>
</tr>
<tr>
<td>c) compensations of checks;</td>
</tr>
<tr>
<td>d) 10 cheque leaves, per month (as long as the client fulfill some requirements) ;</td>
</tr>
<tr>
<td>e) 4 cash withdraws, per month (on the counter or ATMs);</td>
</tr>
<tr>
<td>f) 2 monthly account statement, per month;</td>
</tr>
<tr>
<td>g) 2 transferences of resources to other accounts at the same institution, per month;</td>
</tr>
<tr>
<td>h) Online consulting of balances and most recent operations on the current account;</td>
</tr>
<tr>
<td>i) Annual statement of the fees charged, month by month, in the previous year on the current account;</td>
</tr>
<tr>
<td>Saving account:</td>
</tr>
<tr>
<td>a) banking card to access and manage the resources disposable at the current account;</td>
</tr>
<tr>
<td>b) replacement of banking card (unless in cases of loss, theft, misuse, etc);</td>
</tr>
<tr>
<td>c) 2 cash withdraws, per month (on the counter or ATMs);</td>
</tr>
<tr>
<td>d) 2 monthly account statement, per month;</td>
</tr>
<tr>
<td>e) 2 transferences of resources to other accounts at the same institution, per month;</td>
</tr>
<tr>
<td>f) Online consulting of balances and most recent operations on the current account;</td>
</tr>
</tbody>
</table>
Table 2 – Services classified as priority and their standardized nomenclature, as defined by Circular nº 3.371, on 12.06.2007

<table>
<thead>
<tr>
<th>Service</th>
<th>Supply channel</th>
<th>Identification on statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cadastral fee</td>
<td>-</td>
<td>&quot;CADASTRO&quot;</td>
</tr>
<tr>
<td>Cadastre renewal fee</td>
<td>-</td>
<td>&quot;RENOVAÇÃO DE CADASTRO&quot;</td>
</tr>
<tr>
<td>Replacement of debit card</td>
<td></td>
<td>&quot;2ªvia-CARTÃO DÉBITO&quot;</td>
</tr>
<tr>
<td>Replacement of card to savings account</td>
<td></td>
<td>&quot;2ªvia-CARTÃO POUPANÇA&quot;</td>
</tr>
<tr>
<td>Removal from cheque bouncers cadastre (CCF)</td>
<td></td>
<td>&quot;EXCLUSÃO CCF&quot;</td>
</tr>
<tr>
<td>Cheque stop order</td>
<td></td>
<td>&quot;SUSTAÇÃO/REVOGAÇÃO&quot;</td>
</tr>
<tr>
<td>Counter cheque</td>
<td></td>
<td>&quot;FOLHA CHEQUE&quot;</td>
</tr>
<tr>
<td>Cashier's cheque</td>
<td></td>
<td>&quot;CHEQUE ADMINISTRATIVO&quot;</td>
</tr>
<tr>
<td>Transfer cheque</td>
<td></td>
<td>&quot;CHEQUE TB/TGB&quot;</td>
</tr>
<tr>
<td>Certified Cheque</td>
<td></td>
<td>&quot;CHEQUEVISADO&quot;</td>
</tr>
<tr>
<td>Cash withdraw from current or savings account</td>
<td>counter</td>
<td>&quot;SAQUE pessoal&quot;</td>
</tr>
<tr>
<td></td>
<td>ATM</td>
<td>&quot;SAQUETerminal&quot;</td>
</tr>
<tr>
<td></td>
<td>agent bank</td>
<td>&quot;SAQUEcorrespondente&quot;</td>
</tr>
<tr>
<td>Identified deposit</td>
<td></td>
<td>&quot;DEPÓSITO IDENTIFICADO&quot;</td>
</tr>
<tr>
<td>Monthly statement of current and savings</td>
<td>counter</td>
<td>&quot;EXTRATOMês(P)&quot;</td>
</tr>
<tr>
<td>account transactions</td>
<td>ATM</td>
<td>&quot;EXTRATOMês(E)&quot;</td>
</tr>
<tr>
<td></td>
<td>agent bank</td>
<td>&quot;EXTRATOMês(C)&quot;</td>
</tr>
<tr>
<td>Statement of current and savings account</td>
<td>counter</td>
<td>&quot;EXTRATOMovimento(P)&quot;</td>
</tr>
<tr>
<td>related to transactions in a certain period</td>
<td>ATM</td>
<td>&quot;EXTRATOMovimento(E)&quot;</td>
</tr>
<tr>
<td></td>
<td>agent bank</td>
<td>&quot;EXTRATOMovimento(C)&quot;</td>
</tr>
<tr>
<td>Microfilm or microfiche copy or similar</td>
<td></td>
<td>&quot;MICROFILME&quot;</td>
</tr>
<tr>
<td>Wired transfer (DOC, TED)</td>
<td>counter</td>
<td>&quot;DOC/TED pessoal&quot;</td>
</tr>
<tr>
<td></td>
<td>ATM and other electronic channels</td>
<td>&quot;DOC/TEDeletrônico&quot;</td>
</tr>
<tr>
<td></td>
<td>agent bank</td>
<td>&quot;DOC/TEDcorrespondente&quot;</td>
</tr>
<tr>
<td></td>
<td>counter</td>
<td>&quot;DOC/TEDagendado(P)&quot;</td>
</tr>
<tr>
<td>Wire transfer (DOC, TED)</td>
<td>ATM and other electronic channels</td>
<td></td>
</tr>
<tr>
<td></td>
<td>agent bank</td>
<td></td>
</tr>
<tr>
<td></td>
<td>counter</td>
<td></td>
</tr>
<tr>
<td>Scheduled wire transfer (DOC, TED)</td>
<td>ATM and other electronic channels</td>
<td>&quot;DOC/TEDagendado(E)&quot;</td>
</tr>
<tr>
<td></td>
<td>agent bank</td>
<td>&quot;DOC/TEDagendado(C)&quot;</td>
</tr>
<tr>
<td>Transference of funds to other account in the</td>
<td>counter</td>
<td>&quot;TRANS.RECURSO(P)&quot;</td>
</tr>
<tr>
<td>same bank</td>
<td>ATM and other electronic</td>
<td>&quot;TRANS.RECURSO(E)&quot;</td>
</tr>
<tr>
<td></td>
<td>channels</td>
<td></td>
</tr>
<tr>
<td>Payment Order</td>
<td></td>
<td>&quot;ORDEMPAGAMENTO&quot;</td>
</tr>
<tr>
<td>Advancement of funds to depositor</td>
<td></td>
<td>&quot;ADIANT.DEPOSITANTE&quot;</td>
</tr>
</tbody>
</table>
Table 3 – Standard service bundle, as defined by Circular nº3.371, on 12.06.2007

<table>
<thead>
<tr>
<th>Service</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cadastral fee</td>
<td>-</td>
</tr>
<tr>
<td>Cadastre renewal</td>
<td>2 times per year</td>
</tr>
<tr>
<td>Cash withdraw</td>
<td>8 per month*</td>
</tr>
<tr>
<td>Monthly transactions statement</td>
<td>4 per month*</td>
</tr>
<tr>
<td>Statement of transactions in the previous month</td>
<td>2 per month</td>
</tr>
<tr>
<td>Transference of funds to other account in the same bank</td>
<td>4 per month*</td>
</tr>
</tbody>
</table>

* including those that should be supplied with no cost
1. **How are financial markets distinct from other types of markets?**

An economy’s financial sector is the set of institutions, services and instruments involved in the transference of financial assets and their inherent risks, among economic agents.

Since the financial sector embraces money in all of its forms and functions, it is normally referred to as a macroeconomic matter, and treated as such by governments. However, important micro considerations are usually at the centre of the public discussion on the working of the system.

Financial markets differ from other markets in several, subtle ways. In particular, they provide the economy with mediums of payments, and generate the mechanisms and instruments that act as a vehicle for savings, deposits and the raising of funds from the public. Yet in this very function lies the intrinsic vulnerability of the sector and of the entire economy thereof: a run on bank deposits for instance—a simultaneous withdrawal—, can render banks insolvent and eventually in default, which would severely impair the economy’s payment system.

In order to minimize those and other risks, several solutions have been implemented. Needless to say, the first one is the setting up of a sectoral, specialized government supervisor whose regulations actually aim at cautioning the public resources at risk. This is so precisely because of the additional solutions implemented, namely, that the State takes upon itself part of the banking risks by acting, on the one hand, as a provider of deposits insurance, and on the other as a lender of last resort. This in turn entails a risk of abuse or moral hazard arising from the fact that, given the insurance, its beneficiaries (banks and lenders alike) have fewer incentives to prevent the loss occurrence. The government, therefore, charges the banks a number of “deductibles” that are implicit in its regulations.

As far as the financial sector is concerned, neither economies of scale—that can be very large— nor natural entry barriers account for a non competitive situation. Yet some situations can arise as the result of the possession of a particular resource, none other than information, at the extent it may be monopolized.

Market failures in the financial sector are mainly related to information asymmetries, which allow the privileged side the possibility of operating to the detriment of the other party. This is particularly so if one considers securities markets, a sub-set of the financial sector, since they have no physical nature and so are not directly or immediately assessable by the buyer, who pays for the future delivery of an income flow.

The lack of perfect or symmetrical information makes for the market’s unpredictability, which translates as risk and/or uncertainty. This is why financial regulation points towards minimizing risks and information asymmetries and their subsequent possibility of fraud, to which said market is so susceptible.
2. In what way might competition policy treat financial institutions and products differently as a result of these differences?

Because of the above mentioned particularities, competition policy usually takes a secondary place regarding other regulation goals. Governments generally relegate or even exclude competition policy from their governance of financial markets.

However, when allowed to intervene, competition authorities should assess the expected costs and benefits of their interventions. This requires high standards of technical analysis and a great deal of commitment to the technical analysis of this sector, and the allocation of resources, that some small authorities may not always be in condition to assume.

In the case of Chile the banking sector is regulated by the Central Bank and by the Superintendence of Banks and Financial Institutions, two agencies that are well resourced and that have developed highly technical teams. In principle, competition authorities can intervene in this sector like in any other, with no specific limitation or exception. Yet the presence of these strong sector regulators undoubtedly makes a difference with respect to other -non regulated- sectors.

First, it is possible –and often the case- that the sector specific regulations observe standard competition goals. Yet it is always required that competition authorities advocate for competition goals to be considered a priority by sector regulators, and it is paramount to develop technical skills in order to conduct the necessary analysis at the required standards.

There are certain cases in which, although in compliance with the sector regulations, the conduct of financial agents could be at odds with competition law. The competition system will then have to pursue enforcement actions. Some actions are also triggered by mergers that sector regulators may have previously reviewed in the light of their regulations. The following section presents a brief on a number of enforcement cases.

3. Some recent cases in competition enforcement in the chilean financial sector


3.1.1 Key facts

A regional Stock Exchange accused the country’s main stock exchange of charging fees on inter-Exchanges operations

- Relevant market: Inter-Stock Exchanges operations.
- Trial outcome: Accused convicted. Fees charged on another Exchange’s brokers are uncompetitive and must be eliminated.
- Appeals: Dismissed.

OECD has issued a set of recommendations concerning the competition authorities’ relationship with other regulators, which are applicable in this matter.
3.1.2 Key elements of the decision

According to the Comisión Resolutiva, those fees distorted the market and raised higher entry barriers for emerging exchanges. Besides, they discouraged arbitrage among Exchanges and differentiated markets that—because of their very nature—had to be unified.

3.2 Ruling 639/02: Banking merger

3.2.1 Key facts

Two Congressmen and the Fiscalía Nacional Económica objected the acquisition of a main Chilean bank by a large Spanish bank.

- Relevant market: Banking loans
- Trial outcome: Charges dismissed.
- Appeals: No.

3.2.2 Key elements of the decision

No evidence was found in the relevant market that the behaviour of two banks under the same holding would entail the exclusion of current or potential competitors, neither of price increases or widening of banking spreads. Furthermore, barriers to entry to the relevant market had been decreased, thus reducing the risk of abuse of any dominant position that might be achieved. Restrictions to capital inflows had also been eliminated, thus favouring the raising of fresh funds by incumbent banks. Therefore, the joint control of both banks did not bring about concerns, of a significant risk for competition.

However, the bank regulator was ordered to check the interest rates charged by the banks engaged in the operation, particularly in the districts and regions where one or both banks reached a market share above 50%.

3.3 Ruling 656/02 and 666/02, Information by Commercial Creditors

3.3.1 Key facts

The Comisión Resolutiva was requested to issue general standards on the information to be disclosed by non banking creditors (retailers) to its targeted customers.

- Relevant market: Credit card issuance by department stores and other retailers.

3.3.2 Key elements of the decision

Creditors (“lenders”) addressed to by the rulings were ordered to determine on a daily basis the effective interest rates that were to be charged as well as any other charges that could affect the borrowers throughout the credit period, and to inform their customers of such charges.

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2 This Commission preceded the Competition Tribunal, which is the decisional body since April 2004.

3 The Investigative Agency.
This decision came to be particularly important for it was used as a basis in the elaboration of sector’s and consumer’s regulations.

3.4  **Ruling 704/03: Competition Agency vs. Department Stores, on Credit Cards**

3.4.1  **Key facts**

During the 2002 Christmas season, three large department stores refused to accept payments with banking cards that were allowing cardholders to pay in three instalments with no interest. The competition agency accused the stores of abusing their market power, on the grounds of the actual integration of their retail and credit businesses. Relevant market: retail sales payable with credit cards.

- Trial outcome: each department store was fined US$ 181,000.
- Appeals: Yes. The Supreme Court sustained the Comisión Resolutiva’s ruling.

3.4.2  **Key elements of the decision**

Evidence gathered showed that between 65-75% of department stores’ sales was paid by means of credit cards of their own issuance, largely surpassing the use of banking cards in those sales. The joint refusal by said stores to accept banking cards constituted an abuse of their respective dominant positions, with the aim of protecting their own credit business.

3.5  **Decision 1270/03, and Ruling 29/05: Competition Agency vs. Banking Credit Card Administrator**

3.5.1  **Key facts**

Transbank is an outsourcing firm for the management of banking credit cards. In this role, during 2001 and 2002 the firm acted as a monopolist to the trading stores accepting payments and as a monopsonist to the supplier of computer facilities for its business. It was accused, moreover, of imposing a discriminatory tariffs structure to card issuers.

- Relevant market: the management and operation of bank credit cards.
- Trial outcome: Defendant pronounced guilty.
- Appeals: None. The case went on until an agreement was reached between the firm and the Commission, whereby the former was required to engage in fair practices toward its customers.

3.5.2  **Key elements of the decision**

The trial started before the former Competition decisional bodies and ended before the Competition Tribunal with a partial settlement between the firm and the Fiscalía Nacional Económica that provided for the reduction of the operation fees of debit and credit cards. Moreover, the Competition Tribunal imposed the firm a fine of approximately US$60,000. Finally, the Competition Tribunal decided over the issues which the parties did not agree upon.
3.6 **Ruling 719/03, Risk Rating Agencies’ Merging, 2003: Amendment Advised to the Securities Law**

### Key facts

An insurance company complained that the merging of two risk rating firms was to give rise to the largest, clearly dominant rating agency in the country.

- Relevant market: Risk ratings for corporate bonds.
- Trial outcome: Charges dismissed
- Appeals: No.

### Key elements of the decision

No evidence was found of either concentration or entrance barriers in the relevant market. Competition authorities, however, remarked that the Securities Law made it mandatory for risk rating firms to display and permanently hold a capital equal to or exceeding the equivalent of US $166,000 as of December 2008. Currently, this directive is no longer justified, professional proficiency and competition being the key elements to ensure safety and trust in the relevant market. Consequently, the competition authority requested the government to consider the elimination, or at least reduction, of that amount, a proposal not agreed upon so far.

3.7 **Ruling 15/05, Consumers Association vs. Banking Association**

### Key facts

The National Consumers Association accused the Banking Association of anticompetitive behaviour consisting of price agreements, collusion in the determination of the banking interest rate and transparency failures when charging interests, commissions and other items.

- Relevant market: The banking system
- Trial outcome: Allegation dismissed
- Appeals: No.

### Key elements of the decision

Evidence gathered was deemed insufficient to prove any of the behaviours attributed to the defendant.

3.8 **Ruling 63/08, Bank vs. Retailers’ Credit Cards**

### Key facts

In 2006 two large department stores put undue pressure on their suppliers of electronic household appliances in order for them to resign their participation in a commercial fair organized by a major Chilean bank, thus precluding the fair’s achievement.

- Relevant market: The distribution and retail sale of electronic household appliances and the related market of credit cards.
• Trial outcome: The two defendants were fined the equivalent of US$ 6 million and US$ 3.6 million respectively, grounded on collusion and abuse of their dominant positions.

• Appeals: Yes, before the Supreme Court, which upheld the Competition Tribunal’s ruling, although reducing the total fine in one third.

3.8.2 Key elements of the decision

With the purpose of making a strong collusion case, apart from plaintiff and defendants’ CEOs depositions, telephonic records and e-mail communications were used as evidence, which was an innovation in the Chilean investigative procedures. In determining the amount of the fines, two facts, among others, were considered: first, that the defendants were second time offenders (see Ruling 704/03 above) and then the seriousness of the conduct incurred.
RUSSIAN FEDERATION

The Role of Competition Policy in Financial Sector Rescue and Restructuring

Under the conditions of the global financial crisis the Federal Antimonopoly Service of the Russian Federation undertakes special emergency measures.

One of the measures is significant reduction since November, 2008 of the terms of consideration of applications to conclude transactions from 90 days that are stated in the Federal Law №135-FZ «On Protection of Competition» to 30 days. This reduction enables the economic entities to conclude transaction faster. The terms of consideration of applications on acquisition of stocks (shares), assets and rights in respect of financial institutions are reduced to 5 days.

Besides, according to the Part 14 Article 7 of the Federal Law №175-FZ «On Additional Measures for Strengthening Stability of Banking System in the period till December 31, 2011» the state corporation «Deposit Insurance Agency» does not need to receive the antimonopoly authority’s prior consent or provide the authority with the subsequent notification on acquisition of bank’ stocks (shares) by the state corporation «Deposit Insurance Agency» or by an investor in accordance with the measures on preventing bankruptcy.

Thereby, the Federal antimonopoly Service of the Russian Federation conjointly with the Central Bank of the Russian Federation have forwarded to their regional offices the written explanations on the implementation of this Law.

However, it is worth mentioning the fact that in the period of the existing crisis the Federal Antimonopoly Service of the Russian Federation does not weaken the control over business activity of economic entities.
RUSSIAN FEDERATION

Challenges for Competition Policy in Periods of Retrenchment

The Federal Antimonopoly Service of the Russian Federation (FAS Russia) has devised the proposals on improving the situation in the financial sector and individual industries, which are forwarded to the Government of the Russian Federation and relevant federal executive bodies.

The measures, proposed by the Federal Antimonopoly Service, are aimed at expanding the access of credit organizations to additional financial resources, offered as part of the support measures for the financial market and various industries of the Russian Federation.

The main method for obtaining liquidity by credit institutions without lodging of security is attracting resources from the federal budget for bank deposits and obtaining credits from the Bank of Russia.

Under the current economic conditions, restricting the access of credit institutions to the means of state support on the grounds that they do not have a long-term creditability rating assigned by an international or a Russian rating agency is not justified. FAS Russia proposes that the main criterion for access of credit institutions to the means of state support should be the indicators specified in No.2005-U Instruction of the Bank of Russia “On Assessment of the Bank Economic Position” of 30th April 2008.

To ensure effective control over target use of the allocated funds, FAS Russia sees fit to use the system of special accounts with such spending regulation that allows writing off the funds only for crediting the real sector of the economy, small and medium-sized business entities, and for other purposes determined by the Government of the Russian Federation.

To ensure that funds reach the real sector of the economy immediately, the means of state support should be used under a fixed-term pattern, with mandatory allocation of the finances received by credit institutions for the stated purposes of the loan within a specified period of time, for instance, three months.

Regarding small and medium businesses, FAS Russia proposes to offer the means of state support providing the loans are granted to small and medium-sized business entities at the rate no higher than the rate determined by the Government of the Russian Federation through auctions.

The main principles of such auctions must be fixed starting price and bidding for reduction of transactional margin, related to allocation of resources attracted through the auctions, by credit institutions. Such type of competitive bidding will:

- Reduce the costs of small and medium businesses for loan servicing
- Provide economically and technologically justified rate of return for credit institutions for allocating resources, attracted through the auctions;
- Increase fiscal revenue from depositing funds in the credit institutions.
These proposals were discussed on 21st January 2009 by the FAS Russia’s Expert Council on Protection of Competition on the Market of Financial Services. The session was initiated by the All-Russian Non-Commercial Association of Small and Medium Business “OPORA ROSSII”.

Summarizing the results of the session, the Expert Council supported FAS Russia’s proposals in general.
CHINESE TAIPEI

Financial Sector Conditions and Competition Policy

1. Background

The financial industry of Chinese Taipei, which now accounts for 12% of total GDP, has changed greatly in the past few decades to be of benefit to the economy in addition to becoming a flagship among its service industries. The liberalization and globalization of financial markets have been the government’s key policy objectives since the early 1990s. Market liberalization, which has encompassed allowing new commercial banks to be established, granting more foreign banks access to the market, and gradually lifting restrictions on financial products, has upgraded the quality of financial services, and has given rise to intense competition in the financial markets of Chinese Taipei.

After the Financial Holding Company Act was passed in June 2001, the Ministry of Finance (hereinafter the “MOF”) found itself faced with a growing challenge generated by the ever-increasing mergers between domestic financial services groups or alliances of financial services groups with enterprises in different industries. The emergence of financial consolidations and the increase in cross-sector business made the supervision of the financial industry more challenging and complex, thus making it necessary to have a single financial regulator responsible for the exercise of more professional regulatory discipline. The Financial Supervisory Commission (hereinafter the “FSC”) was thus established in 2004 as the competent agency for maintaining financial stability, preventing systemic risk, and combating financial crime and money laundering through the exercise of differentiated supervision.

The Fair Trade Law of Chinese Taipei (hereinafter the “Law”) was enacted in 1992 for the purposes of ensuring fair competition, maintaining trading order, and protecting consumers’ interests so as to promote economic prosperity. From the perspective of the Law, the position of dealing with competition issues is supposed to be consistent across sectors. However, differences can be seen in the following cases.

2. Examples of Fair Trade Commission Practices

2.1 Case I

A complaint filed to the Fair Trade Commission (hereinafter the “Commission”) had alleged that the deposit interest rates of each domestic financial institution had already been cut, but that prime lending rates were not being sufficiently reduced accordingly, it not only enlarged the spread of banks, but the parallel rate adjustment also implied that there had been concerted action as set forth in the Law.

Although the complaint referred to a concerted action which is per se illegal under the Law, the complainant provided no direct evidence to support the allegation. The Commission had to conduct first a market research to collect relevant market information, such as deposit interest rates and the amount of loan made by each bank, to proceed to investigate the alleged violation.

In the process of conducting the market survey, the Commission found that the levels of the bank interest rates affected the market significantly and it seemed that the limited circumstantial evidence could
hardly substantiate the violation. Therefore, the Commission reconsidered the possibility of approaching this case from different aspects and found it necessary to consult related sector regulators.

As a nation haunted by prior experience with severe inflation and financial crises, stability is always its priority when it comes to policies regarding the development of financial markets. With regard to the methods adopted to handle cases in this field, the competition policies focus more on unfair-competition issues concerning consumers in the financial sector and opinions on competition issues from sector regulators will usually be respected.

After consulting the Central Bank, the MOF, and the Bankers’ Association, it showed that the prime lending rate offered to loyal clients was the lowest short-term lending interest rate. The rate is adjustable and negotiable with regard to the term of credit extension, the details of business dealings and those of borrowers’ credit following the liberalization of the regulation of fixed interest rates in 1985. Lacking circumstantial evidence to show that there are parallel adjustments being made by different banks, the Commission believes that each bank determines its prime lending rate independently.

Taking into consideration the prime lending rate system regulated by the Central Bank tends to rigidify rate adjustments, and is likely to impair the competition of loan rates, the Commission has suggested that the Central Bank request the Bankers’ Association to reconsider the need of the system, including the justification for regulating the prime lending rate to achieve the goal of fairness in the loan market. Furthermore, the Commission has recommended that banks provide borrowers with opportunities to negotiate on rate terms.

2.2 Case II

Before the Financial Institutions Merger Act was passed in 1999, the Commission had been considering how it would cooperate with the sector regulator responsible for the Merger Act to formulate its merger notification procedures, as well as the manners of cross-agency coordination.

Subparagraph 2, Paragraph 3 of Article 13 of the Financial Institutions Merger Act is the main provision stipulating the responsibilities of the Commission which provides: “If the business or financial status of the credit department of a farmers’ or fishermen’s association obviously deteriorates, cannot meet the liabilities of the said association or is likely to harm the benefits of depositors, the competent authority may order the association to assign its credit department to a designated bank. Where the Competent Authority deems the act of assignment necessary to take an emergency measure, and where such a measure does not have any material adverse effect on the competition of the financial market, the bank is exempt from reporting to the Fair Trade Commission of the Executive Yuan in accordance with Paragraph 1 of Article 11 of the Fair Trade Law.”

Prior to the passing of the Financial Institutions Merger Act, merger cases involving struggling financial institutions were reviewed scrupulously by the Commission to avoid disrupting financial order. In similar vein, as the mergers involved important and confidential matters, the handling process of these cases by the Commission as well as its decision would be in accordance with the request of sector regulators. Furthermore, if the market share of a financial enterprise being ordered to merge is less than 5%, or the assets of an enterprise being merged are less than its liabilities, such an enterprise has no plan to resume business and its business almost comes to a standstill, the impact of these enterprises on competition is limited and the Commission may authorize its commissioners to speedily review the cases prior to further submitting and reporting the findings to the Commissioner’s meeting for ratification.

After the preliminary studies and analysis, the Commission believed that it should first clear up several uncertain concepts contained in the draft provision that were relevant to its responsibilities
(Subparagraph 2, Paragraph 3 of Article 13 of the Financial Institutions Merger Act) before its responsibilities as well as the functions of the competent authority, the sector regulator, i.e., the MOF, could be marked off clearly. The main items included:

- What were the types of activities that would qualify merging enterprises to be exempted from filing merger notification to the Commission under the Financial Institutions Merger Act?

- What was the definition of the word “emergency” within the phrase “the Competent Authority deems it necessary to take an emergency measure”, and what were the prerequisites for the determination of “problematic financial institutions”?

- What was the precise standard for constructing the phrase, “such a measure does not have any materially adverse effect on the competition in the financial market”?

Although the discussions at the commissioners’ meetings concluded that the Law is in the position to sustain competition, yet when a financial crisis occurs and the government comes forward to attempt a solution, public-interest consideration is always its main concern and justification for intervention. Therefore, unless the MOF invites the Commission to express its opinions, the Commission will in most situations refrain itself from raising competition issues with the sector regulator. Moreover, the stability of financial market might in the government’s view more urgent a goal than any competitive concerns. It therefore could make the Commission to review the relevant cases, the types of mergers qualified for exemption from filing pre-merger notification under the Financial Institutions Merger Act for example, by a relatively relaxing standard.
CHINESE TAIPEI

Adaptation of Competition Rules, Processes and Institutions to Current Financial Sector Issues

1. Background

Chinese Taipei was relatively unscathed by the Asian financial crisis that broke out in 1997, with rising non-performing loan (hereinafter “NPL”) ratios and an over-banking issue increasingly becoming the major concerns of the sector regulator, the Ministry of Finance (hereinafter the “MOF”). It is for this reason that the MOF adopted the financial reform project in 2001.

In the first phase of the financial reforms, measures were adopted to reduce the NPL ratios, encourage merger activities to harness over-competition in the banking sector, create strong financial supervision by establishing Financial Supervisory Commission (hereafter the “FSC”), and liberalize market by drafting and promulgating new laws and their amendments.

As for the global financial crisis originated mainly from bank failures since the week of September 21 last year, the stock market of Chinese Taipei fell by half over a period of 2 weeks. Within less than 2 months, it dropped further by 24%. Exports also slowed down and even showed sign of negative growth because the onslaught of the financial tsunami resulted in a sharp reduction in consumer demand. The decline in orders affected both the industrial and the economic growth; nevertheless, the possibility of inflation in Chinese Taipei was still low and it is possible that it will slightly reduce inflation and thereby prevent it from eroding the economic growth. By observing various indicators, such as the foreign debt of each country, the ratio of foreign capital in the stock markets, and the short-term debts of enterprises, Chinese Taipei is still a country with a relatively healthier financial industry and its ability to adapt to financial turmoil is also superior to that of several other countries.

However, to cope with the more serious than expected impact brought about by the financial crisis and the economic recession thereafter, Chinese Taipei has expeditiously devised and gradually implemented several economy-stimulating measures or projects. These include, but are not limited to, the following:

- Launching direct talks with China and signing several agreements/MoUs, such as direct air links and maritime transportation MoUs, in order to normalize cross-Strait trade relations.

- Expanding public spending on infrastructure. The total budget allocated for this purpose for the following 4 years amounts to NT$ 500 billion.

- Easing the credit crunch faced by the private sector. For example, the Central Bank has alone lowered the basic lending rate to 1.5% since January 2009 and banking and finance sector regulators have put into place several measures to pump more liquidity/credit into the money market. The Central Deposit Insurance Corporation has announced that all deposits would be fully insured for the time being. This temporary measure took effect on October 7, 2008.
• Distributing consumption vouchers, amounting to NT$ 3,600 per resident, in order to stimulate the general public’s consumption in January 2009 before peak season of shopping for celebrating traditional lunar year holidays, and

• Devising promotion projects to boost our trade, in particular our exports to those places being targeted as new emerging markets.

The financial reforms in 2001 and 2005 were respectively launched by sector regulators for maintaining financial stability, preventing systemic risks, and combating financial crime and money laundering through various supervision. The following cases are provided in order to explain how the Fair Trade Commission (hereinafter the “Commission”) has been dealing with the recent development of financial markets.

2. Examples of Fair Trade Commission Practices:

2.1 Case I

In 2006, the Commission established the “Research Team for Countermeasures on Adjustments to Competition Issues Arising from the Second Financial Reform” to discuss problems related to the harmonization of competition policies and financial policies.

When Chinese Taipei underwent the second financial reform, the following four major policy goals were proposed:

• Pushing the market share of the top three financial institutions to 10% or above;

• Consolidating 12 state-owned banks into 6 banks;

• Consolidating 14 financial holding companies into 7 companies; and

• That at least one financial institution would be operated by foreign investors or have its stocks listed in a foreign country.

The purpose of these policy goals was to encourage financial institutions, by means of consolidation, to expand their scales of operations, improve operation efficiency and the competitiveness in the global financial market, and drive forward the nation as a regional financial service center. Of the said policy goals, the Commission considered that the items concerning a financial institution’s ability to control risk, the release of government shares, and the restrictions on reinvestment in non-financial institutions all came within the domain of financial supervision.

The purpose of the Commission’s merger reviews, including those involving financial holding companies, have always been to maintain trading order and ensure fair competition. They may be quite different from financial sector regulators’ supervision in terms of purposes, issues concerned, and regulatory means. However, they are consistent with the purposes of adequately developing the efficiency of resource utilization, and facilitating economic stability and prosperity.

At that stage, the objectives of the domestic financial policies are to drive forward the consolidation of the financial sector, expand the scale of the economy, and enhance the regional competitiveness of financial institutions. Furthermore, in the development process as the financial sector is gradually being oriented towards centralization and size enlargement, the competent authority over competition law should also cautiously evaluate the impact of such centralization and size enlargement on the market structure,
competition order and the benefits of consumers. The above authority is to give consideration to the overall development of the domestic financial sector under the premise of respecting the market mechanism.

Therefore, in light of the consolidation of financial institutions, which was most relevant to the responsibilities of the Commission in the process of the second financial reform, the “Research Team for Countermeasures on Adjustment to Competition Issues Arising from the Second Financial Reform” of the Commission discussed two major issues, namely, “Financial Market Definition,” and a “Substantial Review of Factors for the Merger Control of Financial Markets.”

2.1.1 Issue 1: Financial Market Definition

As restrictions on banking businesses are gradually being relaxed and new financial products are continuously being created, deposits and loans have no longer been the only sources of revenue for banks. Although the Commission occasionally touches upon the market for by-products in practice, discussions are mainly based on giving special consideration to certain cases, and the Commission does not to provide a general and overall examination of the details of competition among products other than deposits and loans. The research team has thus suggested that, under the premise that the relevant industry information could be obtained, the scope of competition of the banking products market could be defined even more meticulously, for instance by taking into consideration the deposits and loans together with the credit card market (the number of credit cards issued domestically) and the consumer credit market. In this way, the status of banking competition could be more effectively evaluated.

Furthermore, the organization of financial holding companies has been established in Chinese Taipei under the current regulatory framework for governing physical business segregation within the same legal entity. Financial holding companies may reinvest in banking and regulated foreign financial entities, bills finance, credit cards, money trust business, insurance, securities, futures and venture capital, as well as other types of business related to financial market that are approved by sector regulators. Therefore, in order to proceed with an integrated competitive analysis, it is necessary for analysts to obtain information concerning consumer preferences on and price elasticity of various financial products and services, in which financial institutions including financial holding companies operate in different business areas.

2.1.2 Issue 2: Substantial Review of Factors for the Control of Mergers in Financial Markets

With respect to mergers among financial institutions, the Commission shall take into consideration their unilateral effects, coordinating effects, the degree of entry barriers and impairment of market competition. If the restraining effects on competition are conspicuous, the Commission will counter-balance their impact with their likely overall economic benefits.

Furthermore, as for the Commission’s position with respect to the activities of financial institutions engaging in post-merger anticompetitive activities, the following reviewing principle applies. Once financial institutions strengthen their operations, they may provide their trading counterparts with financial products or services at even more favorable prices, or that are higher in quality or more diversified, and the Commission welcomes this development. Nevertheless, after financial institutions are enlarged and become more centralized as financial groups, the integrated resources owned by these financial groups are much greater than those owned by regular financial institutions. The market power of financial groups thus not only tends to be centralized, but financial groups are also in a position that is more advantageous than that of consumers in terms of the provision of require information. Anticompetitive activities may thus result from centralization and the enlargement of financial institutions. For example, two financial institutions that are competitively related to a so-called financial group may restrain business activities mutually, such as by jointly determining interest rates, or service charge rates, or by restraining adjustments in the above-mentioned prices. In such situations, the above-mentioned parties may agree that
they will not poach clients from each other or may jointly refuse to trade with specific parties. If strategic alliance cooperation agreements involve conditions having the effects of price restraints, exclusive dealing, or market division, and are sufficient to affect the market function of the supply and demand for services, this will result in a violation of the provisions concerning concerted actions as set forth in the Fair Trade Law (hereinafter the “Law”).

Furthermore, when financial holding companies or their subsidiaries engage in an act of co-marketing and compel trading counterparts, as a transaction condition, to purchase the products or services of other subsidiaries, it is likely that the companies or their subsidiaries will be treated as violating the relevant provisions set forth in the Law.

2.2 Case II

In addition, prior to the emergence of the recent financial crisis, the Commission and the competent authority, the FSC, negotiated on the issue of the “Applicability of Laws and Regulations Related to Cases where the Financial Sector is Involved in Improperly Marketing Structured Financial Products” in August 2008, following the public’s complaining that financial institutions were improperly marketing structured notes (they were structured financial products).

The laws and regulations pertaining to the responsibilities of the FSC and to the self-regulation of bankers associations have clearly regulated the sales practices concerning the sale of structured financial products. Couple of examples could be made. Enterprises shall evaluate in advance whether the products are suited to their customers. In the sales process, the salesmen shall explain the risks associated with each product, and enterprises shall verify with their customers that they are aware of the risks involved.

At present, the disputes that arise in practice involve mostly that investors argue that salesmen did not explain beforehand the risks associated with “structured notes”. However, after the enterprises actually handled the matters and compiled statistics, the enterprises found that the majority of disputes still arose due to the problem of investors’ perceptions of anticipated market quotations. For instance, the stock price quotations of linked products were not what investors had expected, and did not necessarily have to do with risks which the salesmen fail to inform them of.

The FSC believes that the number of disputes can be reduced if the salesmen of financial institutions indeed comply with regulations, and enterprises should educate their salesmen relevant laws and regulations so as to improve the discipline. At present, requiring financial institutions to take sound recordings in the process of marketing is one approach being taken to provide evidence as to whether proper notification of the risks involved had been provided and whether acts of making people believe in something by mistake took place following the restoration of the marketing process.

The Commission and the FSC held a coordination meeting and proceeded to discuss the necessary coordination of responsibilities and duties. The conclusions reached in the meeting were as follows:

- **Cases on False Advertisements:** With respect to cases where financial institutions’ acts of selling structured financial products involved the dissemination of false, untrue or misleading advertisements, the FSC is to deal with these cases pursuant to relevant financial laws and regulations (such as the Trust Enterprise Act, Banking Act, Securities and Exchange Act, and Insurance Act) first. If the circumstances of these cases involve a violation of the Law, these cases will then be referred to and handled by the Commission.

- **Cases on Acts of Improper Marketing:** With respect to cases involving financial institutions’ acts of improperly selling structured financial products, the FSC is to deal with these cases
pursuant to relevant financial laws and regulations (such as the Trust Enterprise Act, Banking Act, Securities and Exchange Act, and Insurance Act) first. If the circumstances of these cases involve violations of the Law, these cases will then be referred to and handled by the Commission.
BIAC

1. Introduction

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

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

- Was the crisis in the financial sector essentially caused by failure of adequate prudential regulation in the financial sector, or were there also failures of competition policy that may have contributed to the crisis in the financial sector?

- How can competition policy reduce the negative impact of the financial crisis on the wider economy and bring about a return to economic growth?

2. Causes of the Financial Crisis

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

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

Some commentators have suggested that the crisis has some footing in a lack of proper regulatory oversight by financial sector authorities in various countries in relation to certain key areas such as housing mortgage distribution markets, inadequate corporate governance and failure to apply adequate risk management practices. These analysts point to what they believe was a lack of appropriate risk management regulations,’ and an excess of global liquidity as two of the primary contributing factors.³

² In addition to regulatory oversight failure, they also point to perceived failures within many private sector financial institutions to apply their internal risk management and best practices procedures.
In any event, a series of developments appear to have contributed to the crisis:

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

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

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

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

“Adam Smith, the father of modern economics, is often cited as arguing for the ‘invisible hand’ and free markets: firms, in the pursuit of profits, are led, as if by an

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

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


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

invisible hand, to do what is best for the world. But unlike his followers, Adam Smith was aware of some of the limitations of free markets, and research since then has further clarified why free markets, by themselves, often do not lead to what is best. …

Government plays an important role in banking and securities regulation, and a host of other areas: some regulation is required to make markets work…. The real debate today is about finding the right balance between the market and government… Both are needed.\(^5\)

Indeed, in his Inaugural Address, President Obama stated:

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

Some commentators have pointed to the loosely regulated environment for the granting of mortgages and subsequent packaging of mortgages into investment products as a principal cause of the financial crisis.\(^7\) While they have suggested that ordinary "greed" is at the heart of the crisis, BIAC does not agree with that notion. Since the writings of Adam Smith, market experts and analysts have recognized that the profit incentive particularly in certain sectors such as financial markets needs to be subject to proper and effective oversight by government authorities.

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

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

First, the financial services sector which gave rise to these problems is at the heart of every well functioning market economy. Regardless of the industry, the ability to obtain credit is often crucial to a firm's ability to invest and is consequently a necessary ingredient for growth and innovation. Accordingly, problems in the financial sector inevitably affect the performance of other markets for goods and services and the economy as a whole.

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


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

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

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

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

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

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

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

- Should competition law be set aside in the financial sector during a systemic crisis, on public interest or other grounds?
- How should competition agencies apply and adapt general competition policy rules about mergers and anticompetitive conduct during an economic crisis?

BIAC does not suggest or support radical changes to competition policy in these circumstances. It is well-established that the system of open market based economies is more effective in creating consumer welfare, more efficiencies and overall wealth for societies than any other system. Excessive economic controls by central governments have proved largely to be less efficient and less wealth maximizing.

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


Accordingly, in formulating policy measures to address the economic crisis, governments should strive at all times, and to the extent realistically possible, to have normative competition principles form part of the decision-making process. Debates about lessons to be learned from the financial crisis must not be about the "end of capitalism" or the "failure of the market economy."

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

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

- Protectionism should be prevented; markets should be kept open and transparent but subject to appropriate regulatory supervision.

- No matter how tempting it may be to protect and promote "national champions", increased state intervention in the economy should be treated with care.11 The role of state aid and public procurement policy is important, in addition to regulation.

- A certain degree of risk-taking is necessary in order to promote and foster innovation.

- Empirical evidence and analysis should guide the policy action and the implementation of solutions.

- The process of deregulation and increased reliance on competition policy should continue in relation to markets that are presently excessively regulated especially in newly industrialized nations.

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

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

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

12 See The Enforcer: Can Neelie Kroes, Europe’s competition chief, stand up to governments as well as companies?, The Economist, January 10th, 2009, p.59, which suggests that the temporary effective suspension of competition law during the Great Depression led to anticompetitive behaviour, which economists consider to have prolonged the economic downturn.

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

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

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

- As discussed, the financial services sector is at the heart of every well functioning market economy. The maintenance of economic stability is a function that only governments both individually and collectively can effectively perform and is one that cannot be abdicated. If there is any break down or failure, its effects, as recently witnessed, are felt across national borders and throughout market economies. While the failure of other industries may be painful, and may affect numerous stakeholders, the same concerns regarding the potential collapse of the global financial system would not exist. In this regard, the financial services industry is unique and stands separate and apart from all other industries as the keystone of the global market economy.

- Financial regulators should apply their expertise in regulating standards of prudence while competition authorities should apply normative competition provisions in the review of business conduct and significant acquisitions. In this respect, it is important for competition policy makers to show “that competition is part of the solution for benefiting consumers and fostering innovation, competitiveness and productivity”, as brought out by the OECD Secretary-General.14

- In sum, unnecessary and duplicative regulatory oversight can be avoided while ensuring there is effective coordination across relevant government agencies when it comes to regulatory oversight over financial services. The role of competition policy will continue to be an important component of this process.

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

- The need for effective and expeditious antitrust review mechanisms is an important objective even under normal economic circumstances. However, in a time of a global financial crisis, there may be circumstances that narrow the window of opportunity for a particular measure (e.g., a merger) to have the maximum benefit for the overall economy. Accordingly, it is important that competition law enforcement authorities have the flexibility to perform their duties in an expeditious and practical manner.15

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

15 For example, Neelie Kroes, the European Commissioner of Competition, has stated:
In this respect, early, timely and open disclosure and continuing dialogue with parties affected by a competition law review and potential enforcement action is critical. This includes not only the private sector but other relevant government agencies with parallel jurisdictions.

Procedural flexibility should not, however, open the door for uncertainty in substantive results through attempts to incorporate vague and quasi-political public interest standards. For economic growth through business investment, there needs to be relative certainty as to how framework laws such as competition law will operate including likely substantive results. Unnecessary uncertainty can drive away investment, economic growth and the attainment of efficiency. However, this does not preclude some sensible adaptation and extension of existing policies to adjust to current economic conditions in order to respond quickly and pragmatically to changing priorities. Examples might include greater application of the “failing company” defence and greater attention being given to efficiency arguments.

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

This is an area where the OECD Competition Committee could play a leading and constructive role in the future. The OECD Competition Committee has a history of developing Recommendations and Best Practices in areas such as: exchange of information between competition authorities, merger reviews and anticompetitive practices affecting international trade.

It is conceivable that Recommendations and Best Practices (or another form of cooperation such as suggested guidelines) could be developed in areas where there is a need to work in parallel with other government interests, such as where competition law enforcement interfaces with distressed economic circumstances affecting entire market sectors. In this regard, the OECD Competition Committee could draw upon principles which are used in a number of jurisdictions, as a possible area of convergence.16

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

For example, several jurisdictions, such as the European Union, the U.S. and Canada, have a “failing firm” doctrine whereby antitrust authorities will take into consideration whether a firm is failing (e.g., by examining the firm's financial statements, projected cash flows, indebtedness) in determining the competitive effects of a merger. See Part VIII of the EU’s Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, Official Journal C 31, 05.02.2004, p. 5-18 (source: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:031:0005:0018:EN:PDF). See section 5.0 of the U.S. 1992 Horizontal Merger Guidelines (source: http://www.usdoj.gov/atr/public/guidelines/hmg.htm#5). See also subsection 93(b) of Canada’s Competition Act and part 9 of the Merger Enforcement Guidelines regarding failing firms.

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

BIAC would be pleased to offer assistance and input to the OECD Competition Committee in these efforts going forward.

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

5. Conclusion

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


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

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

\(^{19}\) Recognition of this issue and the establishment of applicable protocols have been instrumental to effective coordination in the context of cross-border merger reviews.
BIAC agrees with the OECD Secretary General that the "task ahead is to build a sound governance and regulatory framework that will align incentives, while maintaining a healthy balance between markets on the one hand, and policy interventions on the other."\textsuperscript{20}

\textsuperscript{20} C(2008) 191/FINAL at para. 4.