Competition policy in retail banking before and after the crisis

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Competition Policy in Retail Banking Before the Crisis

Increasing attention to Competition in Retail Banking (RB)

- OECD 2006 Policy Roundtable
- Sector Inquiries by Competition Authorities 2006-2008 (EC Ireland, Italy, Nordic Countries, UK)
- ICN Call for No Special Rules, Full Application of CP to RB

Main problems identified:

- Switching costs (Transactional & Informational)
- Lack of consumer information/ability to compare products
- Regulatory barriers to entry and insufficient (or improper) information sharing
- Cooperation among competitors (in Payment Networks etc.)

The Crisis

In 2007 the **Financial Crisis** struck;

In 2008/9 it became a **Global Economic Crisis**

- Competition concerns traditionally ‘freezed’ during crises/wars (e.g. Fingleton 2009), though evidence suggests New Deal’s ‘cartelization’ delayed exit from recessions (Cole-Ohanian 2004)
- Additional reason to freeze them when relative to financial markets, considered ‘special’ because of fragility and public goods
- Financial stability concerns induced intervention with massive use of state aid, often in a very time-constrained manner
- Mergers used as rescue devices without too much attention to long term competitive consequences (e.g. Vickers 2008)

What About After the Crisis?

- Causes of the Financial Crisis yet unclear, blame put on poor regulation, but many mourn or implicitly hint at a **bad effect of excessive competition in financial markets.**

- **Competition Policy (CP) applied more and more to Financial markets in decades before the Crisis**; Central Banks lost authority on CP enforcement to the advantage of more focused Competition Authorities.

- Problem: do we have **robust evidence on positive effects of competition policy**, particularly in the financial industry, to counter attacks from those who (sincerely or instrumentally) blame financial market competition and suggest to freeze CP?

Recent Debate on Effectiveness of Competition Policy

- Crandall and Winston's (2003) provocative paper claimed that, in general, **competition policy is ineffective**
- Baker (2003) and Werden (2003) disagreed and pointed to the social benefits of competition policy as a deterrence mechanism
- But even in the most established area of competition policy, cartel deterrence, no decisive/conclusive evidence (Whinston, 2006)
- Buccirossi et al. (2009), recent attempt to offer some more robust evidence of positive effects of competition policy enforcement

Buccirossi et al. (2009) 1/2

- Look at **direct link between competition policy** and **efficiency** measured by **TFP growth**

- Develop a set of **Competition Policy Indicators** for the quality of competition law and its enforcement (the **CPIs**)
  - From set of **tailored questionnaires** to the CAs in **13 jurisdictions** and several other sources of information
  - Information on **six policy variables** determinants of **CP** defined as **deterrence of anticompetitive behavior** : the **formal independence** of the CA, the **degree of separation** between the adjudicator and the prosecutor, the **quality of the law**, the **level of sanctions**, the **type of investigative powers**, and the **financial and human resources** of the CA
  - **Separately** for each type of possible competition law infringement (**hard-core cartels**, **abuses**, **other infringements**) and for **mergers,** and at **different level of aggregation**

Buccirossi et al. (2009) 2/2 - results

- Panel regression on **13 jurisdictions** (Canada, Czech Republic, France, Germany, Hungary, Italy, Japan, Netherlands, Spain, Sweden, UK, **EU**, and US) over the years from **1995 to 2005**
- Competition policy appears to exert a **significant and positive impact** on efficiency. **TFP growth.**
- **Rresults robust** to several specification tests and estimation methods and to alternative methodologies to build the CPIs
- The **powers held by the CAs** during the investigations and the **quality of the law** seem to play the most important role
- Controlling for the **quality of institutions**, we find strong **complementarities** between good judiciary institutions and CP

Nice, but Banking is Special! Competition vs. Stability…

Banking industry is indeed special, because of

- Fragility: Runs/Panics, Risk-Shifting/Moral Hazard, Contagion
- Public goods: Payment System, Borrower Screening…

Traditional Trade-off between Competition and Stability

- Bank competition reduces franchise/charter value, increasing risk taking incentives (e.g. Keeley 1990, Hellman et al. 2000)
- Reduces incentives to screening (e.g Broeker 2990)
- Reduces lending standards in booms (see Hans's presentation)

hence…

- Financial markets 'exempted' from Competition Policy in the past

Effects of Stricter Competition Policy in Banking?

‘New view’ in the two decades before the crisis

- Bank competition may increase stability, e.g. reducing interest rates and borrowers’ risk-taking (e.g. Boyd and DeNicolò , 2005)
- Some mixed empirical evidence, slightly more favorable to the ‘traditional view’ (Berger et. al. 2009; but CBs richer than CAs…)
- And Banks became increasingly subject to Competition Policy (e.g. Carletti 2008, Carletti and Vives 2008)

Effects of strengthened CP enforcement in banking?

- Carletti, Hartmann and Ongena (2007) event study : cumulative abnormal stock market returns (CARs) at the announcement that Bank Merger Control goes to Competition Authorities
- Unexpected **increase** for Banks (about + 5%), probably from increase in transparency of regulation with multiple regulators

Carletti, Ongena and Spagnolo (in progress) 1/4

Event study of the impact of changes in competition law on the stock market valuation **of individual Bank M&As**

- How *status* (target versus acquirer) and *characteristics* (domestic versus cross-border) of merging Banks determine CARs
  1. *before and after the changes in competition policy*, and
  2. *with different degree of supervisor discretion*

- How *total CARs,* of acquirer plus target (appropriately weighted) change after the strengthening of competitive merger control for Banks.

Carletti, Ongena and Spagnolo (in progress) 2/4

Dataset on legislative changes in industrial countries (19 countries for 1987 to 2004) compiled by Carletti et al. (2007), identifying events that strengthen M&As competition control

- Study the M&A announcement effects on the involved banks' stock prices directly,
- employ daily market prices of the acquirer and target stocks around announcements,
- estimate daily abnormal returns using standard market model regressions,
- for two event windows, contain 21 and 4 trading days (given we are dealing with merger events that may resulting information leakage focus on 21).

Results A

- Strengthened competition policy **increases valuation of targets and decrease that of acquirers**… increased bidding competition
  - Changes in competition policy increase valuation of target banks in M&As, i.e. their CARs, by 2.7%.
  - Decrease the share prices of the acquirers by 1.0%.
- Discretion in banking supervision partly negates these effects making the bidding for targets by the acquirers less competitive.
- No significant difference for domestic and cross-border M&As

Carletti, Ongena and Spagnolo (in progress) 4/4

Results B

- Total CARs of acquirer + target falls over 4% after the strengthening of competitive merger control
- The fall is entirely driven by domestic M&A, for cross-border M&A Total CARs do not fall

Tentative interpretation:

- Strengthened merger control deters anti-competitive domestic mergers
- No impact on cross-border mergers as they involve banks active in different local markets

Credit Registers, Entry and Retail Banking Competition

DG Comp 2007 Sector Inquiry identifies three sets of possible entry barriers relative to credit bureaus

- *unfair* or *discriminatory access* conditions (e.g. physical presence)
- *partial data sharing* (larger bank likely to maintain info advantage)
- *regulatory barriers* to cross-border info exchanges

In addition, notes the fragmentation of credit information markets along national lines (low cross-border reporting)

Improving information sharing is clearly an important part of future Competition Policy in Retail Financial Services

ECRI Project - Giannetti, Jentzsch and Spagnolo (in progress) 1/2

- Build database on Credit Registers and match with Entry Data
- Look at Entry Mode before and after introduction of Public and Private Credit Registers
- Absent credit bureaus bank entry difficult, adverse selection (Dell'Ariccia 1999), hence entry mostly by M&As
- With credit bureaus less adverse selection, we expect relative less entry through M&As, more through branches
- Branches crucial to retail banking competition, hence entry through new branches should have pro-competitive effects on retail banking markets, entry through M&A less so

ECRI Project - Giannetti, Jentzsch and Spagnolo (in progress) 2/2

Preliminary results:

- Entry through branches (vs mergers) **increases** with the **introduction of a public register** (+0.21%*** in EU27, +0.34%*** in New Members)

- Various **concentration/competition indicators also improve** (eg. CR3 -0.14%*** in EU27, -0.13%*** in New Members; Interest margin -0.012%* in EU27, -0.013%* in New Members)

- Results **less clear for private regisrters,** higher entry through branches in EU-27 (+0.21%***), not significant (-0.07%) in New Members

Concluding Remarks on Sector Inquiries 1/3

- We discussed some new evidence that could be used to support Competition Policy in financial markets against current and future attacks asking for a ‘freeze’
- We suggested that Credit Bureaus can be seen as instruments of pro-competitive policy in future of retail banking markets
- Now we briefly review how Competition Authorities have looked at competition in the retal financial sectors before the crisis, and how this should change after the crisis

Concluding Remarks on Sector Inquiries 2/3

In Carletti et al. (2009) we briefly review the Sector Inquiries on Retail Banking launched by several competition authorities in 2005-2008 (DG Comp, Italian AGCM, OFT, etc.)

- Great merit of looking at competition from different perspectives, relying on various indicators and data
- Attempt to measure efficiencies, that is to look at supply side and not only at demand side
- Though each approach has limitations, for example:
  - Concentration measures are not unambiguously related to the degree of competition in banking
  - Problems in the used efficiency indicators…

Concluding Remarks on Sector Inquiries 3/3

- Difficult to compare across inquiries
  - different geographical definitions of relevant market
  - data seems to have different meaning across countries
  - different ad hoc samples used in the inquiries

A more important open question: price and price-cost margins often taken ‘as they are’; **shouldn’t all these measures, and the analysis, be risk adjusted? What do prices tell us if we don’t fully control for quality/risk?**

To successfully fend attacks Competition Authorities may have to improve on this when dealing with financial markets