

Regulation and Competition in Financial Markets after the Crisis: (some) Open 'Micro' Issues

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Apologies



Paper not yet ready....

Apologies

Some local circumstances did not allow me to finish it...



Plan of the Talk

A. Competition Policy in Banking

- ❑ Is Banking Special?
- ❑ Competition Policy in Banking Before & After the Crisis
- ❑ Effects of CP in Banking: There's so much we don't know...
- ❑ Time to change w.r.t. Banking

B. Financial Markets Regulation

- ❑ 'Large Banks': bank-saving 'megamergers', Too Big To Fail, cross border banking regulation, and the Volker proposal;
- ❑ 'Bank CEO Pay': Regulating bank managers' compensation?
- ❑ 'Bad Regulation': credit rating agencies, forced demand, (badly) managed competition, and the quality of ratings.

A.1 Is Banking Special?

Banking industry is indeed special, because of

- ❑ Incomplete Contracts
- ❑ Extreme scope for MH and AS (Risk-Shifting...)
- ❑ Fragility: Interdependence, Runs/Panics, 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 screen (e.g Broeker 1990)
- ❑ Reduces lending standards in booms ...
- ❑ 'Exempted' from Competition Policy in the past

A.2.1 Before the Crisis

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

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

A.2.2 The Crisis

In 2007 the **Financial Crisis** struck;

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

- ❑ Competition concerns traditionally 'frozen' during crises/wars 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'
- ❑ 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
- ❑ Important role played by DG Comp to limit distortions, that are however very, very large (see Panetta et al. 2010)

A.2.3 What to Expect After the Crisis?

- ❑ Causes of the Financial Crisis not yet fully understood, blame often put on poor regulation, but...
- ❑ Many point at **bad effects of bank competition-innovation, of failure of liberalization of financial markets.**
- ❑ Problem: **do we have any 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?

A.3.1 Debate on Effectiveness of Competition Policy...

- ❑ Crandall and Winston's (2003) claimed that competition policy is ineffective... Baker (2003), Werden (2003) and others disagreed...
- ❑ In my view, even in the most established area of competition policy there is still no decisive/conclusive evidence.
- ❑ Example: neat paper by Miller (2009) on deterrence effects of US Leniency policy on cartels... but what about prices? Sproul (1993), Asker (2009), often do not fall. Bigoni et al. (2009): in the lab non-deterred cartels are more stable and increase prices...
- ❑ In Buccirosi et al. (2009) we offer evidence of positive effects of competition policy on productivity growth, **but we need more evidence, particularly on the banking industry!**

A.3.3 Effects of 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)
- ❑ Mixed empirical evidence, slightly more favorable to the 'traditional view' (e.g. Berger et. al. 2009; Boyd et al. 2009)
- ❑ Banks became increasingly subject to Competition Policy (e.g. Carletti and Vives 2009)

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 in CARs for banks** (+ 5%), probably from increase in transparency and looser regulation with multiple regulators ... may be interpreted both ways.

A.3.4 Carletti, Ongena and Spagnolo, in (slow) progress

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
- ❑ How *total CARs*, of acquirer plus target (appropriately weighted) change after the strengthening of competitive merger control for Banks.
- ❑ Dataset on legislative changes in industrial countries (19 countries for 1987 to 2004) compiled by Carletti et al. (2007), identifying events strengthening M&As competition control

A.3.5 Carletti, Ongena and Spagnolo, in (slow) progress

- ❑ Preliminary Result A: Strengthened competition policy **increases valuation of targets and decrease that of acquirers...**
- ❑ Suggests increase in bidding competition
 - Market valuation of targets increases by about 2.7%
 - That of acquirers falls by about 1%
- ❑ Preliminary Result B: **Total CARs of acquirer + target falls** (over 4%) after the strengthening of competitive merger control;
- ❑ driven by domestic M&A, no fall for cross-border M&A!!
- ❑ Tentative (optimistic) interpretation: Strengthened merger control deters anti-competitive domestic mergers but not cross-border mergers involving banks active in different local markets

A.4.1 Time to Change?

In Carletti et al. (2010) we 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
- ❑ Each approach has of course limitations, for example:
 - Concentration measures are not unambiguously related to the degree of competition in banking
 - Problems in the used efficiency indicators...

A.4.2 Yes, Time to Change.

- 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

One important common issue: prices and price-cost margins typically taken 'as they are'...

But all these measures/analyses should be risk adjusted...

What do prices tell us if we don't control for quality/risk?

- To fend attacks CAs must improve methodology when dealing with financial markets (and other contract mkts)
- CP coordinated with Prudential Regulation (Vives 2010)

B.1.1 'Large Banks': Many Issues often Confused

- ❑ Bank-saving 'mega-mergers' during crisis raised many concerns
- ❑ Large Banks at the root of US Crisis in the 80s (with increased competition, see e.g. Boyd and Gertler 1994)
- ❑ Many large multinational banks involved in the current crisis (RBS, Lloyds, ING, Fortis, Dexia, Citigroup, Merrill Lynch, etc.)
- ❑ Further increased 'too big to fail', or even 'too big to rescue'?
- ❑ Debate on 'Volker rule', separating proprietary trading business ('Casino Banks') from regulated intermediation ('Utility Banks')
- John Vickers' Independent Commission on Banking in UK...
- ❑ EU Debate on cross border banking regulation and the 'problem' of Multinational Banks (i.e. of uncoordinated National Regulators)

B.1.2 Bank Mergers, Merger Control, TBTF, TBTR

Huge Bank Merger wave before the Crisis!!

- ❑ In Canada, Italy, Japan more than half of banks merged in the 90s.
- ❑ In US over 10,000 mergers between 1980 and 2009; N. of independent banks from about 12,000 to about 6,000. Deposits of top five (four with the Wells Fargo acquisition of Wachovia in 2008) largest banks from about 12% to 43%...

Long term concerns on its effects on stability: '...by internalizing what had previously been interbank transactions, consolidation could reduce the liquidity...' (Group of Ten, 2001, p. 20).

Limited efficiencies, TBTF, now TBTR (Dem.-Kunt Huizinga 2010)

Lax Merger Control: National Champions and Regulatory Capture...

B.1.2 Bank Mergers, Merger Control, and TBTF

- ❑ TBTF mostly from lacking effective bank failure resolution processes: if shareholder punished and assets reorganized swiftly...
- ❑ Liberalization/deregulation more than TBTF: Canada, very large banks, highly regulated, no problem (Krugman, Giannone et al. 2010)
- ❑ US bank liberalization in 1982-99; before '82 5.4 average yearly bank failures; up to 131.4 in '82-'90, and to 187.3 after '90...
- ❑ Volker's rule 'easily' applicable, splitting banks not splitting Microsoft unclear whether sufficient: investment bank failure may still lead to crisis, they may still take excessive risks expecting public bailout;
- ❑ Continental EU vs. US/UK competitive problem
- ❑ Alternative: extended (e.g. double) liability: US investment banks where partnerships with much smaller protection from liability in 70s

B.1.3 Cross Border Mergers and Multinational Banks' Regulation

- ❑ Cross-Border Mergers/Banks less Anticompetitive
- ❑ More diversified, Internal Capital Markets improves their stability

Carletti, Hartmann and Spagnolo (CHS 2007, JMCB):

- ❑ Mergers induce risk pooling, ICM improves liquidity management, more resilient, more efficient and more competitive

Calzolari et al. (forthcoming) confirm empirically for MNB:

- ❑ Less correlation local funding/lending; reduce lending less during crises; 'more money', 'smarter money', particularly within EU
- ❑ Need for specific MNB regulation not biased against subsidiaries

However, this is only an individual bank perspective

CHS 2007: Merged Banks with good ICM participate less to interbank market, which may therefore become less liquid...

More research needed!!

B.2.1 Bank CEO Pay: Governance, Competition and Stability

- ❑ Literature on CEO Incentives: how to increase risk taking?
- ❑ In banking now the opposite: how to limit it (and short-termism)?
- ❑ Well known from decades that stocks and options should vest slowly

Are CEO incentives really the problem? Mixed evidence, e.g.:

- ❑ Stulz et al. (2009a,b): CEOs lost a lot in the crisis; share ownership irrelevant; other governance indicators irrelevant; Chance? Casino?
- ❑ Bebchuk et al. (2009): they made much more money before (2000-2009); but still, why losing some? And shareholders also gained...
- ❑ Cheng-Hong-Scheinkman (2010): risk taking and incentives for it if ownership by institutional investors; not a CEO or governance problem, a limited liability/shareholders' problem, externalities...

B.2.3 And Indeed, the Spirit of Bank CEO Pay Regulation...

“It is hard to dispute the idea that excessive focus on short-term incentives and individual performance pumped up the recent credit bubble ... Banks operate in a world where their star talent is apt to jump between different groups, whenever a bigger pay-packet appears, with scant regard for corporate loyalty or employment contracts. ... [A]s one banker says: “These bonuses are crazy - we all know that. But we don’t know how to stop paying them without losing our best staff.”

Against that background, what the members of some compensation committees are quietly starting to conclude is that the only real solution is to start clamping down on the whole transfer game. “If Fifa can stop clubs poaching other players and ripping up contracts, then why can’t the banks do the same?” asks one... “ Tett, FT (2009)

IO-CP translation: “let’s start a cartel, like did football teams”

B.2.2 Bank CEO Pay: Governance, Competition and Stability

Nice 'churning theory' by Acharya, Pagano, and Volpin (2010):

- ❑ Types un-known, losses from risk taking by bad managers long term
- ❑ Short term churning, risk averse managers switching firms continuously to insure themselves (if revealed, then cherry picking)
- ❑ Deliver short-termism, frequent switches and too much risk taking

Implication:

- ❑ "Good" corporate governance & competition "bad for finance";

But

- ❑ High pay not unique to banking (Kaplan_Rauh forth.); MH?
- ❑ Same should happen in innovative industries (biotech, pharma...)
- ❑ Suggested CEO pay reforms all pro-collusive, pay caps (Spagnolo 2005), long term stock-related compensation (Spagnolo 2000)

B.2.4 Bank CEOs Will always do What Shareholders Want...

Issue analogous to individual sanctions for colluding managers: even disregarding cost of pro-collusive effects, there will always be indirect ways to indemnify executives and induce them to do what shareholders really want (unless we use [jail](#))

Micro-regulation of pay: should change for different type of bank managers, very difficult and costly to implement, not clear it will help, clearly it will not be sufficient

In my view, more important to induce bank shareholders to internalize externalities from excessive risk taking, (competition will then force them to fix CEO incentives or pay consequences)

How? Extended liability, higher capital, subordinated debt requirements

B.3.1 The Funniest Story: the Credit Ratings Market

- ❑ General agreement and much evidence that Credit Rating Agencies inflated ratings of complex financial instruments, which are harder to analyze directly for buyers, directly contributing to crisis
- ❑ After the downgrade of Greece policy-makers complained in the opposite direction, as in the 90's; confused policy debate.
- ❑ Large and growing theoretical and empirical literature since 2007 on what went wrong, many proposal on the current regulatory table
- ❑ No room to seriously summarize here, just mention a few main issues, then two fundamental open issues (in my view of course)

B.3.2 Quis custodiet ipsos custodes?

Obvious direct **conflicts of interests** (as for Auditors):

- ❑ CRAs consulting for the rated issuers (helped constructing securities)
- ❑ Directly paid by issuers needing rating (after the 70s)
- ❑ Rating shopping (bought or published only if 'good enough')
- ❑ Ratings lower when unsolicited (unpaid for, blackmail?)

Indirect collusive behavior against naive investors

- ❑ Coarse, simple ratings of complex securities to attract naive buyers
- ❑ They make it hard to evaluate/punish CRAs for poor performance
- ❑ Generous rating allowing for regulatory arbitrage (coming slides)
- ❑ Better informed institutional short-term investors in the position to exploit naive uninformed (but may be they did not get it either)

B.3.3 Obviously Crazy Regulation

- ❑ Increasingly since the 30s, US Regulators used CRAs' ratings to regulate institutional investors, insurance companies, bank capital...
- ❑ The power of law to practically unregulated private firms!
- ❑ Regulated investors forced to buy rated products, issuers forced to get these ratings and choosing & paying CRAs... guess the result!
- ❑ Surprising that some information left in ratings (in the past, thanks to involvement also in unregulated markets and reputational spillovers)

Nowhere else so stupid things (I believe, but maybe we should check!!)

- ❑ Product Safety regulation: public agencies decide minimum standard, implementation outsourced to regulated private parties, then competition among raters only above minimum standard
- ❑ Think at Pharmaceuticals or ECO/BIO regulation, or at that for any other product that has potentially serious risks, besides benefits

B.3.4 Main Open CRA Issue I

- ❑ CRAs already “grilled” by US Congress (for the same reasons) after S&L crisis, East-Asian crisis, dot.com bubble, and Enron...
- ❑ Main (though not all) arguments currently discussed and crazy regulation already present in old reports (see e.g. the conclusions in Cantor and Packer NYFed1994, White 2001, 2010 and references)
- ❑ But nothing was done for the good, but something for the worse... Enron debt rated well until 5 days before bankruptcy; Lehman’s until 5 hours before bankruptcy... No proof CRA rating contain any info.

Interesting open behavioral and political economy questions:

- ❑ Regulators in charge (e.g. SEC) and money managers relying on ratings are all idiots, all corrupt, or just a mixed of the two?
- ❑ How many of them are in jail or lost their job? Why are not government firing them all and hiring normal, honest persons?

B.3.5 Competition, Reputation, and Quality of Certification

- ❑ The crazy demand regulation started already in the 30s
- ❑ In addition unclear supply regulation starts in 1975, SEC creates the opaque definition of Nationally Recognized Stat. Rating Organizations (NRSRO)
- ❑ Entry Barrier: Regulatory Monopoly Conferred to big 3 Moody (40% mkt), S&P (40%), Fitch (15%) with very opaque justification
- ❑ Any entrant acquired by big 3, until CRA Reform Act 2006
- ❑ Then some minor – and irrelevant entry
- ❑ In 2009 new regulation in US and EU but only on obvious direct conflicts of interests (consulting)
- ❑ More competition between CRAs is not coming (White, JEP 2010)
- ❑ **But do we want more competition?**

B.3.2 Too Much or Too Little Competition?

- ❑ Natural economic solution: cancel crazy demand regulation and remove barriers to entry, competition and reputation will fix all problems (if MH of money managers under control)
- ❑ Bolton et al. (2009), White (2010) indeed complain about the existence of large barriers to entry in the credit rating agency market that block competition...
- ❑ 'The SEC believes it is important to foster competition among rating agencies to improve the quality of ratings services, particularly among those providing ratings of structured finance products,' (Meredith B. Cross, director of the commission's division of corporation finance. NYT, September 24, 2009)
- ❑ 'They've benefited from the monopoly status that they've achieved with a tremendous amount of assistance from regulators,' (SEC Commissioner Casey. www.bloomberg.com, April 29, 2009.)

B.3.2 But Relation Competition/Reputation/Quality Unclear

- ❑ Stiglitz (1987), Keely (1990), Kranton (2002): eroding rents, competition may harm reputational forces
- ❑ Calzolari-Spagnolo (2009): when non-contractible dimensions 'core', a cartel between suppliers
- ❑ Bar-Isaac (2006), Hoerner (2002), reputation may be compatible with competition
- ❑ Broeker (1990), Skreta and Veldkamp (2009), externality between competing screeners destroys quality
- ❑ Bolton et al. (2009): 'CRA Duopoly less efficient than monopoly in terms of both total ex-ante surplus and consumer surplus'

B.4.1 The Organization of Supervision...

- ❑ Bo Becker and Todd Milbourn (2009) '*competition leads to lower quality in the ratings market: the incumbent agencies produce more issuer-friendly and less informative ratings when competition is stronger*'.

The entry of Fitch into the credit rating's market has been shown to be associated with greater rating inflation

- ❑ According to a Bear Stearns & Co equity analyst in June 2007, S&P claimed: '*reputation is more important than revenues.*'
- ❑ Bloomberg news cites Moody's CEO Raymond McDaniel stating: '*we are in a business where reputational capital is more important.*'
- ❑ Former executive VP of Moody's Thomas McGuire stated in 1995: '*what's driving us is primarily the issue of preserving our track record. That's our bread and butter.*'

WE DON'T UNDERSTAND RELATIONSHIP REPUTATION-COMPETITION

B.4.1 NEXT?

THE GOVERNANCE OF REGULATORS!!!

THANKS!