The Implications of Capital Regulation for Competition and Consumer Policy in the Banking Sector

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Introduction

- Two important regulatory aims in banking: **stability** & **competition**
- So far, the literature has emphasized a possible negative effect of competition on stability:
  - Charter value hypothesis – Keeley (1990)
  - Bank runs – Vives (2014)
- Also, the costs of financial instability are, in general, easier to measure than the efficiency benefits of competition
  - BCBS (2010): Net present value cost to output from financial crises is 19%-158%, median value 63%
- **Implication:** stability objectives arguably take precedence over competition goals for bank regulators

FT FINANCIAL TIMES

March 11, 2014

BoE accused of complacency over forex rigging claims

The Bank of England was accused of complacency by MPs amid claims that it failed promptly to investigate allegations that benchmarks on London's £5.3tn a day foreign exchange market were rigged.

It is not the first time that the bank has faced claims that some staff turned a blind eye to rate manipulation.

(source: http://on.ft.com/1i36FSR)

Carletti and Vives (2008, p.12):

"… central banks in Europe were too complacent with collusion agreements among banks and even fostered them…"

Carletti and Hartman (2002, p.12):

"it may be that the very influential 'charter value hypothesis' [...] has convinced some countries to counterbalance the competition-oriented antitrust review with a stability-oriented supervisory review of bank mergers."

Introduction (cont'd)

- In consequence, measures may be put in place to promote stability, without regard to their effect on the competitive behaviour of banks
- **Contribution:** To investigate the impact of higher capital requirements on the incentives of banks to take harmful actions in the competition and consumer policy spheres

Why is it important?

1. The harm suffered by consumers when banks infringe competition and consumer protection law is substantial
   - Total cost to UK banks of compensating customers for mis-sold PPI predicted to reach c.£35 billion
   - Cost to UK tax-payers of bailing out RBS in 2008 was £45 billion (but divestments to-date have recovered 66% of public investment)
2. Regulators have started to focus on banks' harmful conduct
   - E.g. UK Competition & Markets Authority's ongoing investigation into retail banking market
   - In order to understand banks' incentives for harmful conduct, and consequently to design effective regulations to counter these incentives, need to understand interactions between stability regulation and competition / consumer policy

Why consider competition & consumer policy jointly?

- Banks interact with both loan and deposit customers
- Loans side: typically anti-competitive, *abuses of dominance*
  - E.g. bundling business current accounts with loans, delays in waiving claims over collateral, abusive conduct towards firms in financial difficulty – CC, OFT, FCA
- Deposits side: typically consumer protection issues
  - Exploit nature of deposit account as 'gateway product' via which to target depositors with sale of add-ons – Armstrong and Zhou (2011)
  - Consumers generally reluctant to shop around, giving rise to "situational monopolies" – FCA (2013)
- Nonetheless, both share the ultimate goal of protecting the interests of **consumers**

Preview of results

- **Results:** Higher capital requirements...
  - increase the incentives to engage in a generic abuse of dominance in the loan market if the dominant bank enjoys a sufficiently large equity funding cost advantage over its rival
  - decrease the incentives to exploit depositors via the sale of an add-on financial product

Model Outline

- Two banks, incumbent (I) and new entrant (N)
- **Stage 1:**
  - banks issue loans ℓ are funded by deposits d and equity e
  - Capital requirement holds as $e_i = \delta \ell_i$, $0 < \delta < 1$
  - **Assumption:** cost of equity is lower for incumbent than new entrant
- **Stage 2:**
  - Banks compete to sell a homogeneous add-on product (e.g. personal loan, credit card) to depositors
  - Depositors incur switching cost if they purchase from non-deposit-holding bank

Initial Equilibrium

- We solve for a dominant bank equilibrium, in which $\ell_I > \ell_N$
- **Stage 2**:
  - given $\ell_I > \ell_N$, banks choose the price at which to sell the add-on product
  - We find $p_I^* > p_N^*$
- **Stage 1:**
  - Depositors anticipate that incumbent will charge higher price in stage 2, demand higher return on deposits
  - Solve for ℓ_I^* and ℓ_N^* – asymmetry in equity cost ensures that $\ell_I^* > \ell_N^*$
  - Incumbent's profits are Π_I^*

Harmful Actions – Loan Market

- We consider a generic abuse of dominance in the loan market, and follow the “raising rivals’ cost” approach
  - Salop and Scheffman (1987), Motta (2007), Katsoulacos (2015)
- **Definition 1:** The harmful action in the loan market causes a positive shock to the new entrant’s cost
- **Result 1:** Increases in the capital requirement increase the incentives of the incumbent to take the harmful action in the loan market if and only if the difference in equity funding costs is sufficiently large

Harmful Actions – Deposit Market

- Depositors display inherent reluctance to switch banks to buy add-on
- Since $p_I^* > p_N^*$, only the incumbent's depositors will consider switching

- **Definition 2:** The harmful action in the deposit market causes a (marginal) increase in the cost of switching in stage 2, which is not anticipated by depositors or the new entrant at stage 1

- **Result 2:** Increases in the capital requirement *decrease* the incentives of the incumbent to take the harmful action in the deposit market

Conclusion

- The paper addresses the following question: when do increases in stability-oriented capital requirements conflict with competition and consumer protection objectives in the banking sector?
- We solve for equilibrium in two-stage game of loan market competition and add-on product sales
- We define two forms of harmful conduct, one in each of the loan and deposit markets, and explore the impact of higher capital requirement on the incentives to take these actions
- Incentive effect in loan market depends on divergence of equity funding costs
- Incentive effect in deposit market is negative – "double dividend" from capital regulation

Thank you

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