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

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What is…

Prudential Regulation?
Prudential regulation seeks to guarantee the *stability* of banks in the face of shocks. (E.g. via the imposition of minimum capital requirements.)

Competition Policy?
Competition policy seeks to prevent *dominant banks* from abusing their market power to restrict competition, thereby raising prices and harming bank customers (be they firms or individuals).

Consumer Policy?
Consumer policy regulates the direct interactions between banks and their *individual customers*, with the aim of ensuring that consumers can take effective and intelligent decisions without being mislead or exploited.

Both competition and consumer policy are therefore ultimately concerned with the social consequences of economic activity and the enforcement of effective government regulation to safeguard these interests

What's special about banks?

Barriers to entry: The nature of the banking sector gives rise to several barriers to entry, suggesting that certain banks will enjoy significant market power and, if left unregulated, may abuse this dominance in their interactions with consumers. (Eg. new banks typically find it more costly to meet requirements for equity capital buffers than do established banks, and bank customers often exhibit very low rates of switching .)

Prudential regulation: In the case of banks, competition and consumer policy have arguably been subordinated to stability objectives. (E.g. Carletti and Vives (2008, p.12)[(1)]: [even before the 2008 crisis] "central banks in Europe were too complacent with collusion agreements among banks and even fostered them.")

(1) Carletti, E. and X. Vives (2008) 'Regulation and Competition Policy in the Banking Sector', *mimeo*.

Why should we care?

Recent infringements by banks in both the competition and consumer policy spheres have been very damaging. Major UK lenders have, as of August 2015, set aside £27 bn[(2)] to cover compensation claims relating to payment protection insurance (PPI) mis-selling alone.

If we consider this as an indicator of the *harm* suffered by consumers (from this single scandal), such infringements appear comparable to the £45 bn cost to the taxpayer of bailing out RBS in 2008, especially as the government's RBS stake can be divested. (In theory, at least, this might even produce a gain for the public.)

FT FINANCIAL TIMES — August 18, 2015

Banks face credit card payouts in fresh mis-selling scandal[(3)]

Two million UK credit card users can claim compensation from this month after being sold unnecessary fraud protection. […] The looming payouts are the latest in a series made by British banks, which have been hit by a wave of mis-selling scandals since the financial crisis.

FT FINANCIAL TIMES — August 17, 2015

Banks braced for billions in civil claims over forex rate rigging[(4)]

Global banks are facing billions of pounds-worth of civil claims in London and Asia over the rigging of currency markets, following a landmark legal settlement in New York.

Academics, like policy-makers, have been predominantly interested in the question of banking stability. To the extent that competition has been considered, it has (most prominently) been to conclude that excessive competition may be harmful to stability, since it erodes banks' profitability.

This focus on banking stability and the view that competition may actually be something harmful in the banking sector, combined with the costs of recent competition infringements, motivates my **research question**: what impact do the policies we put in place to promote *stability* have on the *incentives of banks to take harmful actions* in the competition and consumer policy areas?

(2) Source: http://www.ft.com/cms/s/3/ce089e9a-4271-11e5-9abe-5b335da3a90e.html?siteedition=uk#axzz3kTrhKs00
(3) Source: http://www.ft.com/cms/s/0/5e815dec-45b8-11e5-b3b2-1672f710807b.html
(4) Source: http://www.ft.com/cms/s/0/3b19f516-44e2-11e5-af2f-4d6e0e5eda22.html#axzz3k6e6qmQP

Research Question & Methods

What are the implications of

a. minimum capital requirements[(5)]
b. liquidity requirements[(6)]
c. competition between banking groups and ring-fencing[(7)]

for competition and consumer policy in the banking sector?

The research methods will be primarily theoretical and draw on the industrial organization literature (particularly for competition policy aspects), bounded rationality literature (particularly for consumer policy aspects), as well as the relevant banking literature.

(5) Designed to ensure that banks have sufficient capital "buffers" to sustain losses in times of crisis, and to curb incentives for excessive risk-taking. Higher capital requirements are one of the three key principles of the Basel III Accord, and are also discussed in connection with loss-absorbency in the Vickers Report.
(6) Designed to guarantee that banks do not fall victim to solvency crises, by ensuring that banks hold sufficient cash and liquid investments to meet their projected short term cash outflows in case access to external funding vanishes.
(7) The idea of ring-fencing particularly important banking services (principally deposit taking and loans to individuals and SMEs) and protecting these via tighter capital requirements was put forward in the Vickers Report. Related initiatives include the US Dodd-Frank Act and the EU Liikanen Report.

Outputs, Dissemination & Impact

The project aims to produce one major publishable journal article per research aim.

The work should also be highly relevant to policy-makers, for example the Bank of England's "One Bank" Research Agenda, the Competition Commission's ongoing retail banking market investigation, and the work of the Financial Conduct Authority, which acts as competition and consumer watchdog specifically for the banking sector. In each case, I have contacts via which to promote the dissemination of this research.

I have also agreed with the organiser of the CRESSE conference on competition and regulation (one of the most important of its type in Europe) to organise a special session on competition and consumer policy in the banking sector.