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REGULATION VS. COMPETITION

Regulation can create stability. But it can also hinder the competitive dynamics necessary for a healthy financial industry: the situation in Europe.

The global financial crisis of 2008–2009 has demonstrated that financial stability underpins the health of global and national economies. While many factors influenced the crisis, insolvencies, forced mergers, government capital injections and hasty acquisitions of major institutions fueled the panic. Examples include

Northern Rock (U.K.), Lehman Brothers (U.S.), Bear Stearns (U.S.), AIG (U.S.), Merrill Lynch (U.S.), HBOS (U.K.), Fortis/ABN AMRO (Netherlands, Belgium, Luxembourg) and Hypo Real Estate Holding (Germany).

Arguably, the crisis was fueled by a vicious cycle in which fears over the potential downfall of a single financial institution reduced confidence in

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other institutions. To minimize future economic risks, global political leaders and regulators have made stability a top priority since the 2008–2009 crisis. As examples:

- The G20 has committed to clear over-the-counter (OTC) derivatives through central counterparties and to encourage their trading on exchanges in order to reduce counterparty credit risks and enhance transparency.

Despite the recent emphasis on stability, most politicians and regulators feel that competition plays a vital role in the financial sector.

- The Basel III framework raises the quantity and quality of banks' capital requirements and introduces liquidity standards. It aims to reduce the probability and severity of future banking crises while protecting financial stability and economic growth.
- The European Financial Stability Facility (EFSF) was created — and later enhanced — to help indebted euro-area countries. Its bonds have already aided Ireland and Portugal.

THE THORNY DILEMMA: STABILITY VS. COMPETITION

Despite the recent emphasis on stability, most politicians and regulators would agree that competition plays a vital role in the financial sector. It drives down prices and improves

service for customers and performers.

Yet competitive markets have losers as well. As winners gain market share, less efficient competitors lose customers, become insolvent or are acquired by other companies.

European regulators and politicians clearly face a dilemma: They want to inspire trust among savers and investors by helping stable financial institutions thrive. They know that even the possibility of insolvency or bank failure could cause widespread panic and damage.

Yet efforts to improve stability by ruling out the possibility of insolvency run counter to the natural market dynamics. Strong competition means insolvency risks for the least efficient, weakest players that can't match competitors' prices and services.

To complicate matters, different public authorities have been given statutory responsibility to pursue one of three conflicting objectives:

- Central banks and treasuries try to protect financial stability
- Antitrust authorities promote competition and prevent monopolies
- Some regulators and legislators must simultaneously promote stability and competition

In the European Union, the Directorate General for Economic and Financial Affairs (DG ECFIN) and the European Central Bank (ECB) have the role of ensuring financial stability, while the



Directorate General for Competition (DG COMP) enforces European competition policy.

Similarly, the Directorate General for Internal Market and Services (DG MARKT) of the European Commission must reconcile these opposing goals in the legislative proposals it makes to the Council of Member States and the European Parliament.

For example, following Basel III, DG MARKT suggested increasing bank capital requirements to give banks a larger buffer to withstand financial shocks. It might seem hard to fault measures that promote stability. But in fact, higher capital requirements hinder competition by making it more difficult for new players to enter the market.

Moreover, by making capital requirements larger and more complex, regulators also increase compliance costs, which in turn drives consolidation and reduces the markets' competitive vigor.

THREE OUTCOME SCENARIOS FOR THE STABILITY-COMPETITION RIVALRY

How will regulators and legislators escape from the stability-competition conundrum? Will one objective be prioritized over the other? What outcomes are most likely, and what are the strategic implications for companies in the European financial sector?

The most prudent course of action would be to develop a strategy for each of the most likely scenarios:



THE STABILITY SCENARIO. In this situation, regulators and legislators favor financial stability over competition. The recent multinational government emergency rescue of French/Belgian/Luxembourg bank Dexia shows that EU politicians and regulators still hesitate to let large financial institutions become insolvent.

Given ongoing political instability and financial market turmoil, policymakers may be willing to reduce competitive pricing pressures, helping financial companies earn greater margins and staving off insolvencies and the instability that follows.

THE COMPETITION SCENARIO. In the second scenario, authorities enforce competition policies despite the risk of financial instability. Regulators and legislators may believe that the financial crisis has finite boundaries and that the long-term value of competition outweighs short-term

stability risks. But given all of the pro-stability pan-European initiatives now under way, unbridled competition is unlikely in the short term.

THE BALANCED SCENARIO. Finally, it's likely that regulators and legislators will continue their attempts to find that elusive middle path that balances

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stability with competition. As a result, industry stakeholders should expect that DG MARKT will continue to weigh competition arguments against financial stability concerns in issuing its legislative proposals.

This scenario is unsettling for financial firms, because legislators may decide their fates — insolvency or survival — case by case rather than “by the book.” This means that firms with a stake in such matters must influence the political debate in their favor. Winners will probably be those who act quickly, build a strong case for their position, and find allies who support their cause.

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In a balanced competition-stability world, financial market stakeholders should recognize the importance of early positioning. Stakeholders who engage constructively with regulators

— not just stating problems, but offering creative solutions — can help shape their decisions.

To have the greatest success in favorably influencing the policy debate, stakeholders should:

- Establish a broad base of support among a diverse constituency, including other market players as well as nongovernmental organizations, the media, shareholder advocacy organizations and the general public
- Anticipate other stakeholders' opposing arguments and plan to counteract them
- Enlist industry organizations to advance their viewpoint
- Most important, build a solid, fact-based economic foundation for any stability or competition viewpoint. Data should clearly show officials how taking the preferred position in the competition-stability debate will benefit the industry, consumers and the market in the long term.

Unintentionally, the ongoing political tension between competition advocates and pro-stability legislators has created a new field of competition among financial firms. It is no longer enough to serve customers, develop new products and operate efficiently. Now, to capture market share from weakened competitors or to simply survive until their fortunes rebound, financial organizations must help shape the debate. ■

The views expressed in this article are those of the author and not necessarily those of FTI Consulting, Inc., or its other professionals.