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Agenda

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Bust that trust: a new era?

In the UK, the Leader of the Opposition has called for reform of 'broken markets', and market share caps for current accounts and small business lending, enforced by the new Competition and Markets Authority. Does this usher in a new era of 'trust-busting' competition authorities? We comment from an economic and public policy (but non-political) perspective

Competition authorities around the world are faced with a policy question about how proactive they should be. This applies both to their enforcement powers (do they wait for the next cartel whistle-blower or complaint about an abuse, or do they actively seek to initiate such investigations?) and to their activities in competition 'advocacy'.

In certain sectors where liberalisation has occurred, especially those that are subject to economic regulation, there may be a requirement for the competition authority to promote competition. This will normally have two effects. First, subject to other, potentially conflicting duties on the regulator, decision-making practice will seek to promote competition, including the introduction of new entrants. Second, the authority may choose on its own initiative to assess which parts of the market are working well following liberalisation.

By way of an example, the regulator for Britain's railways, the Office of Rail Regulation (ORR), has a duty to promote competition. In determining whether rail paths should be allocated to new-entrant passenger operators, the ORR applies the 'not primarily abstractive' test. It has to balance its duty to promote competition (which would imply that it should allocate paths to a safe, well-resourced new entrant) against other duties, including that it should take into account government budget requirements (which would imply that it should not increase revenue risk to rail franchise bidders, as such risk would require them to demand increased compensation from government). In addition, the ORR consults regularly on a programme of market investigations across the sector, and in recent years has reviewed the passenger rolling stock leasing market, access to rail freight sites, and the supply of signalling services to the infrastructure operator, Network Rail.

The newly established Financial Conduct Authority (FCA) is another example. It is the only regulator of a major financial centre in the world that has an explicit competition objective (in addition to the usual consumer protection and market integrity objectives).[1] It has the objective to 'promote effective competition in the interests of consumers', which marks quite a step up from the duty of its predecessor, the Financial Services Authority, to 'have regard to […] the need to minimise the adverse effects on competition'. The FCA has already taken a much more proactive approach and launched competition investigations and conduct reviews in markets that it does not consider to be working well.

Change in the air, or hot air?

Speaking on 17 January 2014, UK Leader of the Opposition, Ed Miliband, said:[2]

> On day one of the next Labour Government, we will ask the Competition and Markets Authority to report within six months on how to create at least two new sizeable and competitive banks to challenge the existing high street banks.

He also stated:

> And we will go further too. In America, by law, they have a test so that no bank can get too big and dominate the market. We will follow the same principle for Britain. And so under the next Labour government we will establish for the first time a threshold for the market share any one bank can have of personal accounts and small business lending. Preventing mergers and acquisitions over this threshold.

Mr Miliband also mentioned energy companies alongside banks, and 'reform[ing] broken markets' more generally. What does this mean for competition policy in general?

It is important to separate the following few strands in Mr Miliband's speech.

- Banks should not be 'too big to fail'—an important driver of political decision-making is avoiding the next financial crisis and, specifically, ensuring that the next time a bank experiences financial distress, it is affordable to the sovereign government responsible. Previous *Agenda* articles have discussed this issue and appropriate policy responses,[3] but in this context it is important to understand that the driver leads Mr Miliband to reach for market share caps (discussed further below) and the introduction of new competitors as the appropriate regulatory responses.

- There should be sufficient competition in sensitive markets—Mr Miliband mentions current accounts, small business lending, and energy. In principle, liberalisation should deliver better services at lower cost. So, to the extent that these markets do not have characteristics suggesting that increased competition would be detrimental (such as a minimum efficient scale, where firms below a certain size cannot be as efficient as larger players), removing barriers to entry might be an attractive objective.

- Regulation should be aimed at overcoming market failures—Mr Miliband is keen to seek reform in 'broken markets'; in other words, he would look for the state to intervene where there are market failures. The majority of economists would agree with this premise (while noting that governments can also fail), but the degree of emphasis placed on this statement will be all-important: does Mr Miliband want to see proactive competition authorities beginning investigations wherever they see markets failing, or does this, in reality, mean a continuation of the status quo?

Market share caps?

As many investigations by competition authorities have shown, high market shares are not necessarily a bad thing. They are often a sign of competition working well: if a company delivers excellent quality of service, low prices and innovation, and provided that there is an effective threat of competition ensuring strong incentives to keep performing at a high standard (which will be the case where barriers to entry are low and consumers are active in making choices), there is no need for a competition authority to intervene.

Mr Miliband wants to avoid banks, in particular, becoming too large and dominating the politically sensitive current account and small business lending markets. One explicit control that he mentions is preventing mergers and acquisitions that would push companies over a specific threshold. Leaving aside questions of measurement (clear product and geography definitions would be required for this, as well as an acceptable definition of market share), Mr Miliband seems to suggest that a successful bank that gains market share could well end up also breaching the threshold.

This raises a number of questions: what is a company to do when faced with an impending breach of the cap? Stop marketing and selling in case the cap is breached? Reduce quality? Tell its staff to stop innovating? Economics tells us that market share caps will have the unintended and paradoxical effect of dampening competition rather than increasing it, and competition authorities typically avoid imposing market share caps due to these poor incentive properties. Another policy tool that Mr Miliband commits to is requiring the UK Competition and Markets Authority (CMA) to produce a report six months after the election of a Labour government on how to introduce two new banks into the UK system. In a scenario in which the CMA were tasked with this role, but the proposals did not work in practice, or market outcomes did not improve, there would most likely be a debate as to who was responsible—the CMA or the government.

In addition, reducing barriers to entry or promoting entry may not be sufficient to improve market outcomes if consumers are not active in shopping around—in order to improve outcomes, there is a need to tackle any demand-side behavioural biases, as well as the supply side of the market.

Promoting competition?

The CMA in the UK is tasked with promoting 'competition, within and outside the UK, for the benefit of consumers'.[4] In other words, it will not seek to increase competition unless it is in the interest of consumers. This recognises that competition is a means to an end, rather than an end in itself.

The CMA is currently consulting on its first Annual Plan,[5] and it is clear that the new Authority is focusing—at least initially—on promoting competition in regulated industries:[6]

> In regulated sectors – which represent a significant section of the economy – promoting competition will be a priority, in collaboration with sector regulators.

The CMA is also going to undertake a new Strategic Assessment during 2014/15 to identify priority markets more generally for investigation or action. How decisions will be taken regarding these priority markets, how they will be investigated, and what actions will be taken, is unclear, but could well encompass a more proactive stance, subject to the proviso that the investigation and any resulting actions are likely to benefit consumers. It is not clear whether these 'regulated industries' include the financial services sector. As indicated, the FCA has launched competition investigations in a number of financial services markets, and more investigations have been planned. One area in which the CMA's predecessors seem to have been less successful is in promoting competition across government. An example is decision-making guidance applied by government departments—arguably one of the first ports of call for competition authorities seeking to make an impact on the economy. In its WebTAG tool, the Department for Transport has one of the most sophisticated investment decision tools of any UK government department. However, WebTAG does not require scheme promoters or those evaluating investment options to consider their relative impact on competition in the transport market.

It remains to be seen to what extent the new CMA—and, indeed, competition authorities elsewhere in Europe—will look to promote competition actively in otherwise unregulated markets. Promoting competition may well be restricted to politically sensitive markets (and it is not clear whether this includes, for example, the delivery of services by the public sector), although, in principle, the primary duty of the CMA would seem to have much wider reach. Again, it is worth remembering that competition is a means to an end in delivering benefits to consumers, rather than something that should be promoted for its own sake.

Conclusions

The recent speech by Mr Miliband has pointed to competition authorities becoming more proactive, seeking out opportunities to improve market outcomes. There is a particular interest in deploying this form of regulation in the banking sector, which is politically prominent, and delegating to the CMA decision-making powers on how to increase competition is one potential strategy. Market share caps are unlikely to prove workable given their poor incentive properties, but in general Mr Miliband's suggestions are consistent with a different, but potentially workable focus for competition policy—on regulating market failures. How much change is envisaged depends on whether the proposals are purely aimed at banking and energy, or go much wider.

[1] The only other financial services regulator that has a competition objective is the Malta Financial Services Authority.

[2] Miliband, E. (2014), 'One Nation Economy', speech at Senate House in London, 17 January.

[3] See, for example, Oxera (2011), 'The cost of supporting banks: lower than expected?', *Agenda*, July; Correia da Silva, L. (2012), 'Don't run before you can walk: EU banking reform and the need for economic analysis', *Agenda*, June, and Westman, H. (2013), 'Structural reform in the EU banking sector', *Agenda*, February.

[4] Enterprise and Regulatory Reform Act 2013, Section 25(3). See also Competition and Markets Authority (2014), 'Vision, values and strategy for the CMA', January.

[5] Competition and Markets Authority (2014), 'Competition and Markets Authority Annual Plan consultation document 2014/15', January.

[6] Competition and Markets Authority (2014), 'Competition and Markets Authority Annual Plan consultation document 2014/15', January, p. 5, para. 1.8.