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CONSUMER CREDIT AND COMPETITION: THE PUZZLE OF COMPETITIVE CREDIT MARKETS

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Consumer credit markets in the US present a puzzle. As competing explanations are offered for the recent sub-prime mortgage crisis and skyrocketing default rates for unsecured consumer credit,[1] two seemingly inconsistent facts confound the discussion. While consumer credit markets are, by all accounts, competitive, consumers find themselves saddled with unsustainable amounts of debt that accrues interest at rates that are exorbitant. How could these two situations exist simultaneously? It is an article of antitrust faith that competitive markets are good for consumers. In a world of competitive markets, there is a limited role for consumer protection. So long as products are transparent, then consumer preferences, price competition and the invisible hand should produce market nirvana.

Coexisting with this puzzle are competing market-failure based explanations for the consumer credit crisis. Some of these explanations focus on the "supply-side". In the market for home mortgages, the shift from a face-to-face, bank-based, invest-and-hold model of mortgage origination to a capital markets-financed model where mortgage brokers originate mortgages for sale to securitisation pools is blamed for creating conflicts of interest between investors and underwriters that inflated an investment bubble. Other explanations focus on the "demand side". Irresponsible consumers are accused, en masse, of borrowing beyond their means and endangering the safety and soundness of financial markets one McMansion at a time.

The post-mortem has led to conflicting prescriptions: (i) do nothing and let the market correct itself; (ii) regulate the supply side for conflicts of interest and transparency; (iii) regulate the demand side for transparency; or (iv) regulate the demand side by prescribing and proscribing certain loan terms. The meme of

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1 In the second quarter of 2009, the charge-off rates for credit cards and commercial mortgages were the highest seen since such data have been kept. Federal Reserve Statistical Release, "Chargeoff and Delinquency Rates on Loans and Leases at Commercial Banks", available at http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm (accessed on 2 February 2010). Historically, residential mortgage charge-off rates have hovered well below 0.25%. In the second quarter of 2009, the charge-off rate was a shocking 2.34%. Similarly, the consumer credit card charge-off rate, generally between 4 and 6% over the last 10 years, is currently at 9.55%. *Ibid.*

"competitive credit markets" is frequently interposed, however, to argue for the first option over the other, more intrusive and nominally anti-market alternatives of either market regulation or consumer protection. In this essay we seek to add nuance to the competition story and seek, in the process, to propose a comprehensive regulatory architecture for consumer credit that uses the dynamics of competition constructively to channel the behaviour of mortgage underwriters, regulators and consumers.

In order to untangle the relationship between competition and consumer credit, one must recognise that there are really four "competition" stories that need to be understood. The first is the standard competition story between and among lenders for customers. The second is competition between and among lending technologies driven by regulatory arbitrage. The third is competition based on product innovation and differentiation, and the fourth is competition among regulators. Each of these "competition" stories offers a distinct set of lessons for those who would try to reform consumer credit markets. Without understanding each of the four stories, and the interrelationship among them, reform is likely to miss the mark.

In this short essay, we will seek to sketch the paradox of competition and consumer protection. Then we will sketch out each of the four competition stories, some potential competitive benefits and the respective market pathologies of each. Next, we will evaluate a number of pending US regulatory reforms in light of these concerns. Finally, we will suggest the outlines of a coordinated regulatory architecture that seeks to channel the various "competitions" in productive directions, without unduly stifling those competitive efforts. Given the space (and time) constraints involved, much will have to be fleshed out during conversations at the Antitrust Marathon.

A. Competition and Consumer Protection: the Puzzle

Consumer credit markets changed fundamentally after about 1980, with the development of a secondary market for home mortgages and the ability of credit-card-issuing banks to securitise their credit-card receivables. The changes accelerated through the 1990s, and the freight train went off the rails in 2008 and 2009. Prior to the advent of securitisation, savings and loans issued home mortgages for their own account, and revolving consumer credit was in its infancy. Economists predicted that lender risk aversion, coupled with the inability to price discriminate between high- and low-risk borrowers, would lead to credit constraint.[2] In such an environment, consumer protection had little role. In a

[2] JE Stiglitz and A Weiss, "Credit Rationing in Markets with Imperfect Information" (1981) 71 *American Economic Review* 393.

world where consumer credit was undersupplied, underwriting standards did an imperfect, but probably overzealous, job of protecting consumers.

After 1980, however, everything changed. First, credit reporting made it possible for national lenders to determine the creditworthiness of borrowers on a local level and price loans accordingly. Second, the ability to securitise loans made it possible for lenders to engage in risk-based pricing, and match the risk attributes of loans to the risk preferences of investors. As such, a market emerged for issuing credit to riskier customers.

So far the story is all positive. Changes in lending technology eliminated a market imperfection. This improvement in the market for consumer credit had a second order effect, however, that may have been unanticipated. Consumers without experience managing credit had access to credit in unanticipated amounts. The greater riskiness of these borrowers led unsurprisingly to increases in consumer defaults. Again, so long as this risk is properly priced, the market for consumer credit will increase social welfare, albeit with a higher level of default.

As we have explored elsewhere, however, the unalloyed welfare enhancement story breaks down if one has concerns about consumer rationality, and we do.[3] Cognitive psychologists and researchers into behavioural decision making have raised serious doubts about the ability of many consumers to make rational decisions about consumer credit. These doubts arise from cognitive limitations of consumers, many of whom have difficulty comparing or understanding basic loan terms, from heuristic biases, such as optimism bias and endowment effects, and from time-inconsistent preferences, sometimes referred to as hyperbolic discounting. Many consumers are not particularly good at maximising their preferences where credit is involved. Indeed, confusion about consumer credit distorts consumption decisions as well as borrowing decisions. To make matters worse, these cognitive and heuristic biases are well understood by lenders, who use teaser rates, back-end fees and balloon payments to hide the true cost of loans.

This disconnection between consumer decision making and consumer preferences goes part way toward untangling the puzzle of competitive credit markets and the need for consumer protection. While lenders do not want to "sell" more credit than borrowers can repay, they may very well wish to sell more credit than the consumer would want or need if they truly understood its costs. As such, competitive credit markets may not be welfare maximising.

[3] S Block-Lieb and EJ Janger, "The Myth of the Rational Borrower: Rationality, Behaviorism, and the Misguided 'Reform' of Bankruptcy Law" (2006) 84 *Texas Law Review* 1481.

B. Consumer Credit and Competition

Consumer error is not the only culprit. In this section, we will identify four distinct ways in which competition plays a role in the market for consumer credit, and how it influences the shape of potential consumer protection. We will seek to identify the competitive benefits and pathologies that exist in the market for consumer credit, and are looking forward to a discussion that develops these further.

1. Price and Terms Competition

As noted above, the market for consumer credit is generally believed to be competitive. Lenders make a profit, but the profit does not appear to be "supernormal". Indeed, even though the costs of sub-prime loans are often shockingly high, sub-prime lenders do not appear to earn a higher rate of return than prime lenders.[4] The costs of administering sub-prime loans, along with higher default rates, eliminate much of the benefit associated with what appears to be "price gouging". However, for the reasons described above, the fact that the market is competitive does not mean that it is welfare maximising. Indeed, the problems in consumer decision making suggest that the market for consumer credit may create a pair of "lemons equilibria".

The first "lemon" is the most surprising. Price competition is usually thought to be immune from "lemons" problems. Consumers understand price, and they usually understand what the product is that they are buying. This is often not the case with consumer credit. Price competition often takes the form of price concealment. Worse yet, competing on the basis of price and transparency is a truly bad marketing strategy where selling your product turns on concealing its true costs.

The second "lemon" is, not surprisingly, the market for non-price terms in consumer credit. However, those "non-price" terms are often where the true costs of the loan lie. Default interest rates, universal default terms, prepayment penalties, events that terminate favourable teaser rates, and so on are all related to the "price" of the loan, but they are not presented as part of the principal amount, the term or the interest rate. For some loans, this is fair, and the default terms are truly held in reserve for non-payment. However, for many consumer loans, the default rates, late fees and penalties are part of the business model, and where the real profit lies. Because these terms are both non-transparent, and designed to capitalise on consumer heuristic biases, it is unlikely that competition will, by itself lead to the elimination of these problematic terms.

[4] C Yom, "Limited Purpose Banks: Their Specialities, Performance, and Prospects" [2005] *FDIC Banking Review* 19, 28.

Thus, the market for consumer credit, while competitive, is not welfare maximising because of the two "lemons" equilibria described above, or, to put it another way, because of the intentional blurring of the line between price and non-price competition.

2. Competition among Lending Technologies: Regulatory Arbitrage and Agency

The second form of competition is the competition among lending technologies. From the Depression forward, consumer lending was handled by banks. Mortgages were issued by savings and loans, or by national banks, but were held by the bank for their own account. Banks' capital requirements were regulated, and the safety and soundness of the banking system was monitored by the various bank regulators, the FDIC, the OCC and the Federal Reserve. With the emergence of a secondary market for home mortgages, the regulatory architecture began to change. The moving of mortgages out of banks and into mortgage pools had the effect of moving mortgage lending out of the more traditional bank regulatory structure.

Initially, Fannie Mae and Freddie Mac exercised some control over the shape of the securitisation market by limiting the loans with access to the secondary market to prime, conforming loans. Later, however, as a secondary market emerged for sub-prime and non-conforming loans, the effect of securitisation on mortgage terms reversed. It led to a proliferation of products and a proliferation of terms that were no longer subject to the requirements of either bank regulators or the standardising force of Fannie or Freddie. As such, the shift from bank-based mortgage finance was driven, to a certain extent, by regulatory arbitrage. Instead of being regulated by bank regulators for safety and soundness, the new "capital markets"-based mechanisms for financing mortgages were regulated by securities regulators solely for disclosure. As such, the new "securities" products began their own competitive process of innovation, from RMBS to CDO to CDO-squared, all the way to synthetic CDOs, where no mortgages were involved at all. Oddly, the demand and supply sides did an about face. There was such a strong demand for mortgage-backed financial products that the supply of "mortgages" could not keep up with the demand.

This change in lending technologies had the result of creating a number of agency problems. One set appeared at the originator stage, where originators would choose which mortgages to keep for their own account and which to sell to the secondary market. A second set of agency problems appeared with regard to the gatekeepers—appraisers, underwriters and rating agencies—all of which were compensated based on volume of deals rather than on the success of those deals or the accuracy of their ratings.

These competitive pressures placed increased burdens on two flawed decision makers. First, consumers were faced with a plethora of products, sold, in various

ways, as providing them with access to the American Dream (be it a house or flat screen TV). Second, investors were presented with a plethora of non-transparent mortgage-backed investment products that were sold as "investment grade", when it is now by no means clear that the ratings agencies understood, in any meaningful way, how to assess the risk of these complex financial products. On both the consumer lending side and the capital markets side, the institutions that were "selling" consumer credit were competing for suckers (including home buyers about to start a family and grandparents hoping to be able to augment their retirement nest egg).

3. Competition through Product Development

Another aspect of the market for consumer credit has been the development of new financial products. Prior to 1980, there were a limited number of so-called "plain vanilla" mortgage products: 30 year and 15 year fixed rate mortgages, and perhaps an adjustable rate mortgage. Even during the initial stages of the development of mortgage securitisation the secondary market for home mortgages was controlled by Fannie Mae and Freddie Mac. Access to the securitisation market was limited to the plain vanilla prime mortgages, and so, at least initially, the development of mortgage-backed securities actually operated to regulate the terms of most small to medium-sized consumer mortgages.

As the RMBS market moved beyond the prime mortgages that Fannie and Freddie could purchase, new, exotic products began to emerge. High loan to value mortgages, ARMs with teaser rates or balloons, and home equity loans, used to consolidate credit card debt, proliferated. On the one hand, these product innovations provided many options to consumer borrowers; on the other, they may have created the opportunity for confusion and deception that has led to the crisis of overleverage we currently face.

4. Regulatory Competition

The final competition story is one of regulatory competition. Regulation of consumer credit is currently quite decentralised under US law. Different pieces of the consumer credit market are regulated, respectively, by the Federal Reserve, the OCC, the FTC, the FDIC, the SEC and cognate state regulators. Each of these regulators has concurrent responsibility for a different piece of the consumer credit market, and none has primary responsibility. The banking regulators are focused principally on the safety and soundness of the banking system, while the SEC is focused principally on protecting those who invest in either shares of banks or in asset-backed securities. Only the FTC has consumer protection as part of its central mission, but it has no particular expertise in or responsibility for financial instruments. This balkanisation of regulation has led Elizabeth Warren and Oren Bar-Gill to propose a single, centralised Consumer

Financial Products Safety Commission (discussed below).[5] We see considerable advantages to such an agency, but we also recognise that there are considerable advantages to a decentralised regulatory architecture. Multiple agencies are harder to capture. Multiple agencies can divide up tasks according to comparative competencies. Multiple agencies can provide multiple poles in a policy debate, and can spur or retard regulation. On the other hand, it may also lead to lack of coordination. The effects of regulatory competition are ambiguous. They can lead to cooperation, or to conflicting mandates and coordination problems.

C. Towards a Coordinated Regulatory Architecture

We are thus faced with two failed markets—the demand for consumer credit and the institutions for supplying it, and four stories of imperfectly channelled competition. The puzzle of consumer protection therefore requires an approach to regulation that simultaneously recognises the limitations of consumers, the realities of consumer lending and the limits of lending institutions. Protecting consumers on the demand side must be done in a way that is sensitive to its effects on the supply side.

With that in mind, it is useful to identify the key problems identified above:

1. consumer cognitive limitations and heuristic biases (consumer protection);
2. the conflicts of interest that arise between loan originators and securities purchasers as a result of the shift from face to face lending to capital markets financing (investor protection); and
3. the need for coordination among regulators (regulatory competition and coordination).

Also, in the long run, securitisation is not going away, so the realities of the capital markets require products that can be standardised and pooled.

Each of these problems suggests an attribute of the regulatory architecture that we propose. First, there must be regulation of the terms of consumer loans that encourage transparency, and, more importantly comprehension of loan terms and loan consequences. Second, many of our concerns about complexity and moral hazard are alleviated when a lender is lending face to face, with the expectation that they will hold the loan to term. Third, regulation of consumer credit requires more than regulation of loan terms and products. It also implicates the safety and soundness of the banking system and the integrity of the securities markets.

[5] O Bar-Gill and E Warren, "Making Credit Safer" (2008) 157 *University of Pennsylvania Law Review* 1.

D. Evaluating Current Reform Proposals

A brief evaluation of the various reform proposals that are currently on the table simultaneously shows the risks of a non-coordinated approach, and suggests some of the attributes of a coordinated architecture. The two major proposals on the table are (i) the "Miller Bill",[6] which proposes an "appropriateness" standard for consumer loans and would give the borrower a defence if the loan were deemed unsuitable: and (ii) the above-mentioned proposal for a Consumer Financial Products Safety Commission. In addition, for comparison purposes it is worth taking a look at the manner in which the UK has regulated consumer loans.

First, the Miller Bill suggests that mortgage originators should be subject to liability and borrowers should have a defence to payment where it can be shown that the lender originated an "inappropriate" loan. Appropriateness is measured by reference to the borrower's ability to pay, and also with regard to the interest rate and housing market risks embodied in the loan through rate adjustments, balloon payments and/or prepayment penalties. The problems that such an appropriateness requirement addresses are real but, to the extent that it uses a "standard" to impose liability, there is considerable worry about the effect that such a requirement might have on the ability of originators to securitise their loans.

Second, there is a pending proposal for the creation of a Consumer Financial Products Safety Commission that would pass on the safety of financial products.[7] The Consumer Financial Products Agency Act would transfer enforcement authority and rule-making authority under a wide variety of consumer lending statutes to this new agency. There is a lot to recommend such an idea. In particular, through its rule-making authority, the new agency could generate safe harbours and sustainability requirements that were both more specific and more flexible than those written into a statute like the Miller Bill. However, it also raises some concerns. First, to the extent that it sets out particularised limitations on the forms that loans might take, it may stifle innovation. Second, to the extent that it is granted exclusive jurisdiction over consumer financial instruments, it may be subject to capture.

Third, in evaluating these two proposals, it may be worth taking a look at the UK experience, where they have an existing architecture involving standards-based regulation of consumer finance, managed by a single regulator. As we have discussed elsewhere, the UK consumer lending markets have functioned well, notwithstanding an appropriateness standard that lacked the safe harbours contained in the Miller Bill. Indeed, while UK investors have suffered because of

[6] Mortgage Reform and Anti-Predatory Lending Act, HR 2529, 111th Congress (2009).

[7] The proposed text of the Consumer Financial Protection Agency Act, HR 3126, 111th Congress (introduced on 8 July 2009), is available at http://www.financialstability.gov/docs/CFPA-Act.pdf (accessed on 2 February 2010).

their exposure to the US sub-prime market, the UK has not had a similar sub-prime crisis involving its own citizens.[8]

E. Knitting the Proposals Together

In our view, the regulation of consumer credit transactions requires a merging of each the three approaches embodied in the pending regulatory reforms. First, what is needed is a mix of standard based regulation and safe harbours. The "appropriateness" standard of the Miller Bill represents a suitable default. Mortgage originators should take care not to saddle borrowers with unsustainable debt, and where they do, borrowers have reason to complain.

At the same time, the possibility of an "appropriateness" defence will render most loans unsecuritisable. As such, this would significantly raise the cost of consumer credit, and this is not desirable. In our view, therefore, to the extent that there are well-understood transparent and straightforward loan products and basic documentation requirements, many consumer loans could be subject to an appropriateness safe harbour, and therefore available for securitisation. By contrast, non-standard loans would be subject to a more amorphous appropriateness standard. Such loans would not be forbidden, but the lenders would not be able to sell the loans to the aftermarket, and would have to hold them for their own account.

A key role of any proposed regulator would be to define the terms and establish the outlines of these safe harbours. As such, the two pending proposals might work better in tandem than standing alone. Finally, it seems to us crucial that the jurisdiction of any proposed financial services regulator would be concurrent rather than exclusive. Risks of capture are significant where consumer protection is concerned, so a decentralised approach is probably preferable.

F. Conclusion

The observations and conclusions contained in this essay are obviously quite tentative, and the competition stories, in particular, are not fully or rigorously developed. Much of the discussion about consumer credit has involved advocates of consumer protection talking past experts on bank and securities regulation. Competition scholars have played a relatively minor role, while the meme of competitive credit markets and the need to preserve competition and innovation have been offered by the financial services industry as reasons to stay the hands of the regulator. We hope that this paper and the discussion at the Antitrust Marathon will go part way toward adding nuance to this role currently played by "competition"-based arguments in the policy discussion.

PROF JANGER: First I want to thank Philip and Spencer for organising the Antitrust Marathon. My quadriceps will forgive you shortly. Spencer told me I had five minutes and I understand at a marathon one has to pay close attention to one's splits, although sometimes they are aspirational. I will get the major ideas out on the table first and then fill in some of the detail later.

What I am hoping to do is look at a single economic sector and explore the role that both competition and regulation play at a time when the sector is, quite frankly, in crisis. First I will describe one puzzle and two market failures stories that help solve the puzzle. Then I will argue that the discussion about competitive consumer credit markets is different from the usual focus on ex ante product competition. In order think about consumer credit, you need to pull apart the idea of competition and see how the many different roles it is playing in the regulatory architecture. Finally, I will talk about two legislative proposals and whether can be tied together to channel competition.

First, the puzzle? It is generally agreed that credit markets are competitive; nobody is making a supernormal profit; what could be going on here? So how can there be a competitive credit market and at the same time a market that has ended up in crisis both on the supply side and on the demand side due to consistent over borrowing and over-lending?

The key here is that two overlapping market failures are in play: a supply side market failure and a demand side market failure.

The supply side market failure on the supply side, the failure is a product of the shift from a bank-oriented approach to mortgage and consumer credit financing, to one financed through securitisation. This could largely be viewed as a deregulatory move but also had some important market perfecting attributes, in that it increased the liquidity of debt. However, agency problems and gate keeper failures emerged because regulatory institutions didn't keep up with the shift.

On the demand side the problem was alluded to by Max in his paper. It goes by a number of names: the behavioural economics problem; the stupid consumer problem; or the too dumb to have a credit card problem. But the problem is more complicated. There are really three different things going on. The first is a cognitive problem. There are limits to what rational consumers can be expected to. My co-author, Susan Block-Lieb, did a paper a number of years ago where she showed that if you look at the ability of consumers to understand the difference between interest rates on two fully disclosed loans about 40% of the relevant consumers couldn't do it. So even with transparency, you are going to end up with a significant number of ill considered consumer choices.

The second set are the ones we would call behavioural in the sense they are based on consumer biases and heuristics. The third is time-inconsistent preferences. Paradoxically consumers will charge roughly a much higher interest

rate for a one week than for a one year loan—they emphasise current consumption and current fees over back end costs.

Susan and I have written a bigger article called the "Myth of the Rational Borrower",[1] which lays this out in more detail. The concern is not that consumers are all irrational, but that there are enough irrational borrowers that it becomes policy relevant. More importantly, all of these irrationalities point in one direction. They incline consumers toward over-borrowing.

So a market failure on the supply side led to a shift to a marketing mode. This, in turn, led to a tendency to overland. And, a demand side market failure led to a tendency to over-borrow. Together, these two market failures had a perfect storm effect that manifested in 2008. Thus a failure of regulation and a failure of consumer protection ended up having safety and soundness consequences for the banking system.

If you are going to regulate in this area, you have to define the role of competition, and I think there are four competition stories, not just one—all inflected by behavioural economics and public choice theory.

First you have the classic competition story about price and terms competition. Here I think the thing to think about is the lemons equilibrium, Consumers generally don't differentiate particularly well on the basis of non-price terms. As a result, market participants don't have an incentive to compete on the basis of non-price terms so the competitive equilibrium is suboptimal.

To make matters worse, in the consumer credit market, since consumers aren't good at understanding the price terms of consumer credit, you can end up with a lemons equilibrium on price terms. These self-reinforcing lemons equilibria make it difficult for competition law to be viewed as the way of solving the problem.

The second competition story is one of regulatory arbitrage. Competition between sets of lending institutions, banks and shadow banks or securitisation pools or capital markets is appropriate. But one of the important pieces of the competition was a regulatory arbitrage. Securitisation pools are not subject to lender capital requirements. Therefore a bank that loaned through a securitisation pool could capitalise on this regulatory loophole. Because the securitisation pool wasn't a bank, a bank could then buy the assets and the loan would count as capital, not a risky loan. This loophole made it profitable to lend through securitisation without really thinking through whether you were trading of some of the institution's comparative advantage as a lender.

The third competition story is an innovation story. If you regulate too much you are going to cut off product development. This may be true, but there are

[1] S Block-Lieb and E Janger, "The Myth of the Rational Borrower: Behaviorism, Rationality and the Misguided "Reform" of Bankruptcy Law?" (2006) 84 *Texas Law Review* 1481.

two different types of product development: product development that is welfare enhancing and gives consumers additional options and product development that is designed to capitalise on the lemons problems that I identified earlier.

Finally you have got a regulatory competition problem. Institutions with overlapping jurisdiction seek to regulate consumer protection. While one would think that this would lead to a race to regulate, that hasn't been the model at all. Instead there has been a tendency to hang back. As such, it is hard to tell whether you are going to get a race to regulate or a race to capture. When you have got overlapping jurisdictions how it plays out in any particular context is going to be relatively difficult to figure out.

In evaluating the two legislative proposals that are on the table, one needs to keep all these things in mind. First, there is the proposal for a consumer financial products safety administration—a single centralised FTC for consumer financial products where all of the regulatory authority that is currently located in a variety of banking and securities institutions would be transferred to this agency as the primary though not exclusive regulator. I have a significant reservation about this approach in that you don't know whether it is going to become a powerful regulator or a one stop shop for interest groups.

The second proposal is to create an appropriateness standard that basically says if you make a loan that is unsuitable because of its terms or unsuitable because of its interest rate there will be a defence to enforcement. This has the problem—or maybe it is the benefit—that it becomes virtually impossible to securitise the loan. Opponents therefore say that this will kill the securitisation market. For me, however, this is a feature rather than a bug. The response, which I think is fruitful, is to think about which types of loans ought to be safe harboured. I think that these two proposals, taken together, suggest a potential architecture for coordinated regulation. I will stop there—working that would be tricky; we can talk more about how one might do it.

MR MARSDEN: Thank you very much. That's a perfect example of how our spotlight on one sector can reveal all sorts of concerns about competition and confidence and consumer protection issues. Philippa, you are going to broaden it out a little bit?

MS WATSON: Yes, I am going to broaden it out a little bit in the sense that I am going to look and see how competition policy or how competition laws and rules can be required to be departed from in the public interest. This is a very interesting debate and it is an issue which is very far from being solved It is a moving target—running alongside ever-changing government priorities. Now, even the most ardent fans of competition will admit that competition policy and competition rules cannot solve all life's problems. Increasing importance is being attached to public interest. Both government, and I mean government on a

global level, and consumers require that certain matters which they regard as being in the collective interest ought to have prime importance. I am thinking about environmental policy, I am thinking about financial stability, I am thinking about research and development, innovation, going down the ladder social policy, long-term unemployment, integrating the disadvantaged into the labour market, a lot of considerations which the public say look, these problems have to be sorted out and they must be allowed to be sorted out unhindered or at least hindered only to a minimal extent by competition regulation. So we are then confronted with the question as to what extent can the competition rules be constrained in the public interest and how should that constraint be managed. Let me start with Article 10 of the EC Treaty, which is a loyalty clause. You are in the club, you must not prevent the club from performing properly. This was the article which the ECJ used in the *GBNO* case, 1977,[2] which now seems a century away. The Court there said look, Article 10 requires that a Member State does not either introduce or maintain in force rules which deprive the competition rules laid down in the Treaty of their effectiveness. This brought the state firmly within the ambit of the competition rules; hitherto the situation had been a bit sketchy, and we must remember that was 32 years ago, when the state was a more powerful economic entity—in the sense of the sectors which were subject to its uncontested monopoly control than it is today.

Article 10 is a clause which covers all areas of Community policy. At the same time we have throughout the Treaty provisions which allow a certain departure from the Community rules under specified or prescribed circumstances. With respect to competition law we have a number of tools which we can use, to protect the public interest. We have first of all Article 81.3, which requires the balancing of a number of factors. Secondly, we have the definition of an undertaking and that defines the scope of application for the competition rules. An undertaking is an entity which engages in economic activity. Therefore, if an entity is engaging in activity which is not economic, it is not subject to the competition rules. Now, generally those types of services which the state delivers as part of its prerogative—as opposed to being part of an economic activity—are non-economic in nature, I am thinking about education, health, welfare.

But recently the division between economic and non-economic sectors has become less clear. In the past, if one looked at the provider of services, that in itself would be a strong indication of the nature of those services.

You would be able to say this is an economic activity and that is not economic activity because traditionally the state didn't engage in economic activities and traditionally the state was the main provider of non-economic services. Business was not in the business of welfare provision, put it that way, it didn't regard itself

[2] Case 13/77 *SA GB-INNO-BM v Association des détaillants en tabac (ATAB)* [1977] ECR 2115.

as being a charitable organisation looking after the population as a whole, that was the prerogative of the state or the state's duty. Now things have become slightly blurred, the state is engaging in economic activity and there are undertakings engaging in economic activity but which may have, as part of their business, a certain amount of non economic activity.

This has required us to look at how you divide the one activity from the other—and thus determine the application of the competition rules. This issue has been resolved mainly through the case law of the European Court of Justice, which at times has had to grapple with conflicting and sensitive issues. In a series of cases that have come before the Court you have, for example, providers of pension funds, providers of healthcare services, providers of other types of social services which argue they are not subject to the competition rules because they are engaged in uneconomic activity. So the Court has had to say wait, let's see if this is actually true. What the Court has done is it has focused on the activity, the nature of the activity, how it is carried out, and it is decided on that basis where the dividing line is between economic and non-economic activity. So we have moved away from looking at the characteristics of the provider of services and supplies to looking at the entity as a whole—the nature of its business, its customer profile, etc.

The third tool we have in our toolbox is services of general interest. Now, services of general interest divide themselves again into to services of general interest or what the public authorities classify as being of general interest and they may be subject to specific public service obligations to ensure their balanced delivery This again is a moving target; what is a service of general interest in France, for example? It may not necessarily be a service of general interest in the United Kingdom, Germany or Poland. It is a variable concept, taking on a different meaning from state to state. Services of general interest are again divided into non-market services and market services, and that reflects the same principles that define the concept of an undertaking.

Non-economic services are generally out of the scope of the competition rules. Services of economic interest fall in principle within the competition rules but, because they are services of economic interest which must be provided to citizens, the providers of those services may receive a softer and more flexible, a more attenuated treatment under the competition rules, which, if applied with full force, might prejudice the delivery of the services in question. This generally takes the form maybe of an exclusive licence. Services have got to be provided. The market will not provide all those services. The citizen needs them: it may be argued the citizen has a right to them. I am really waiting for that case when the citizen invoking his right to an essential service goes to court and says I need a decent X service and I am not getting it. That is going to be great fun, where you get the citizen's right to decent quality of service pitched against the obligations of the service provider.

Let me go back to my train of thought—which I hope I haven't quite lost—and it is that services of economic interest must be provided to the citizen. There are many economic operators who may not be prepared to provide those services unless they are protected from excessive commercial risk, by means, for example, of an exclusive licence. This may mean they get the exclusive right to exploit the whole or part of a market without being subject to the full rigour of competition rules.

Markets may be opened up to competition. Parts of those markets may not attract competition, may not attract an interested undertaking. It is not very attractive to run a bus route around the Aran Islands, but it may be very attractive to run a bus route around Dublin. Come to think of it, is not very attractive to run a bus route around Dublin—traffic is such that it is very difficult to get the bus moving.

So what do you do in order to make sure that your citizens, no matter where they are placed, have got equal access to services and essential services? You say to certain economic operators I know you want to service the Dublin area, you will make a lot of money there, you will make a lot of money if you service Manchester, but I want you to do the Outer Hebrides and the Aran Islands, and for this purpose I will give you special concessions or I will pay you to do it. So what you do is you give an operator the right to operate a service and you impose on that operator a public service obligation. Either he or she must, as part of the licence conditions, pledge a certain degree of service, and if that isn't enough to attract that operator to the market additional incentives must be offered, for example, a guaranteed cash payment. In paying that operator, what are you doing? You are giving state aid, so you fall into another box of problems, but you are whipped out of that box if you pay the operator no more than is necessary for him to operate that service plus a reasonable profit. Any more and you are back into the state aid box because you are giving him more than he actually needs to perform that service with a reasonable profit so you are actually favouring one operator over and above his competitors by paying him more than necessary to provide those services.

So we have public service obligations, and that is the way citizens are provided with essential services to which they are deemed to have a right. Another tool in our little box is universal service. The principle of universal service implies that there is an obligation on suppliers of services and goods, to provide at an affordable rate a guaranteed quality service to all citizens who wish to use that service.

Now, I need to swivel around rather quickly because I am rather short of time and I am a very slow runner. Taking stock, we see that there are tools in our box to manage and balance conflicting policies. Such a balancing act is not as easy as it would appear. This is a very tricky area of the law and it is constantly evolving

and it requires an on-going balancing of interests, which it is often very difficult to do.

Moving on, how do you increase competition in areas in which the government has traditionally been the exclusive operator? For example, we have a plethora of government policies. Government now regulates every atom of our existence. How do you make sure the government acts in a competitive way when formulating policy and law? The tool that is generally used—and this has been developed relatively recently—is the impact assessment toolkit. This has been developed first of all at EC level, where we see that all policies have got to be looked at under a certain number of criteria to make sure they don't conflict with each other. For example, their impact on small and medium size enterprises has to be determined, as well as the cost for the proposal in issue to either government or the Community. A series of criteria that have been developed against which Community policies when they are being developed or when legislation is being formulated must be judged.

Secondly, the OFT has developed the principle of impact assessment—2005, recently revised in 2009, I believe—in collaboration with the Better Regulation Executive, under which any legislative or policy proposal must be looked at under four heads to see the extent to which it is going to have an impact on the competition. The OECD in 2007 produced its impact assessment toolkit very much modelled on the OFT model in which it says policy initiatives—legislative initiatives—must be looked at under a number of criteria. Now, you can apply your instrument of impact assessment at various points in time. You can take it out when policy is being formed so that policy doesn't actually translate into anticompetitive action, be it legislative, regulatory or otherwise. You can invoke it at the legislative stage when you have actually got your legislation drafted and therefore you can see very clearly what you are talking about. There is an advantage there. Or you can go retrospectively, and this is what they did in Australia, you take out everything on the statute book, put it on the table and say right, let's get through all of this and see what is on our legislative book which is anticompetitive. Can the anticompetitive elements be reduced and still achieve the objectives of that legislation?

The Australians decided to do this in the mid-1990s. They said to themselves look, we are a bit sluggish down here at the end of the world so we had better do something about ourselves, and they did. A report was produced that examined 1,700 pieces of legislation. Amendments were made to the legislation to make sure that competition rules and policy were respected insofar as possible without sacrificing the objectives of that legislation. It was done at various levels, and this means impact assessment can be done at various levels. Impact assessment should be done at any level which makes regulation, so it can be done at the level of the local authority which regulates taxis and buses for example, central government—anywhere in between the top and the bottom of the government

chain. The Australians actually paid for this. There is nothing that cannot be achieved in this world, it seems, with money. The Australian government paid the state legislatures per capita of population for engaging in this exercise. It proved very successful. The Australian economy duly went up enormously, the economy was richer by billions of dollars, so, although near the end of the exercise the Australians were paying out about 800 million dollars, in fact they recouped that several fold because as the economy grew they got more taxes, et cetera. It did give that kick start which the Australians felt they needed when they started to look at the situation in 1993.

A similar technique has been applied in Korea and Hungary. Mexico has done it ,and I think it has been done a bit in Latin America. One last word: whatever constraints are put on competition policy, they should be and are certainly in Community law subject to two principles. One is the principle of proportionality: you do no more than is absolutely necessary. You do not depart from the competition rules any more than is necessary to achieve whatever public interest objective you are trying to achieve and you stick to the principle of equality, you treat your operators equally. I'm sorry that this contribution to the debate has been in more general terms than I would have wished, but I am struggling to get to the finishing line within a respectable time limit. I'm perfectly prepared to discuss my thoughts further.

MR MARSDEN: Thank you very much, Philippa. Would that your last principle—proportionality—be possible to be implemented when you have these bigger beasts out there who couldn't care less about competition.

MS GOGGIN: Great paper and great response. There are, I think, a huge range of issues. The one I wanted to focus on is in terms of when to depart from the competition rules, what the standard of proof should be and, in particular, what the standard of proof should be in difficult economic times. Because some of these issues, for instance, environmental policy, unemployment, regional issues and so on, have been played out through state aid decisions and through competition decisions over many years. But particularly when you have a financial crisis there is a lot of calls for knee jerk responses which limit competition. The difficulty from my point of view I think is in terms of the benefits that competition policy brings to consumers and to the economy in general, there is a whole history, there is the economic backup saying this is a good thing but in times of crisis you get a political knee jerk response saying, for instance, in Ireland we have had restrictions on the application of the competition rules in mergers in the banking sector. Now, this was a while back, and in terms of explanations for the financial crisis I think "some of our financial institutions being too small to survive" came just after "it was all the fault of short sellers attacking Anglo Irish", and maybe just before "some of our financial institutions

are too big to fail", and after that it was "Colonel Mustard in the study", I can't remember all these. The issue of competition policy in difficult times, I know John Fingleton has written about this recently, and John Evans and Carol Boate from the Competition Authority here have had a very incisive article in the competition press,[3] but it seems a rolling back of the competition rules is being achieved at a very low threshold of proof. It applies to mergers because you have the failing firm defence in the banking sector being mooted as something more than it is but also a push for national champions for consolidation and so on.

There is really no substitute for having a proper discussion about the economic pros and cons of these, but equally when these things are being put forward the argument is "there is no time to have that discussion and it's not going to happen". I don't have a solution to this, I am just putting this forward as a problem. Similarly, just to comment on the regulatory impact assessment: I have done a bit of work on that in Ireland and I think it really only works when you have genuinely considered alternatives, because [in] imposing it simply as an administrative requirement you tend to get a retrofitting of the arguments to the decision that has already been taken. So they read like *Goldilocks and the Three Bears*, because you come along and you look at this one solution and that won't work because it's too strict, and you look at this other solution and that won't work because it's too lenient but, surprise, surprise, you come to the one you were going to do all along and that fits just right. So that is a kind of depressed statement there about the difficulty of maintaining the integrity of competition policy in difficult times.

MR ELITHORN: I thought a very interesting paper and a very thorough response too. I am a pessimist and an optimist on this one. I am a pessimist because I don't think the competition community always sells its message well here and I think, although you say even the most ardent competition advocate would accept there are other things, I have sat at tables where that doesn't come across and I have sat at the OECD financial services forum where there was a clear split in the room between those that were saying our precious competition rules are being trampled over and those that said these are extraordinary times, how do we make sure that we preserve as much of the principles as we can? So I think there is still quite a long way for the competition community to go in selling itself in this context.

The reason I am an optimist is because I think there is an awful lot to sell and an awful lot that can be done and, if you engage early enough in the process, there are many occasions where through proper advocacy a better solution can be found that both achieves the public policy objective and maximises the

3 J Evans and C Boate, "Competition Policy and Enforcement in an Economic Crisis" (2009) 16(8) *Competition* 208.

benefits of competition in that process, whether that is by considering competition for the market versus competition in the market and which deals with some of the state aid issues. If you say for public policy reasons we will pay a subsidy for the Aran Islands, let's have a competition for who can do it in these circumstances, at the best price. That preserves the benefits of the competitive process.

I think one of the lessons from the financial crisis is that a time of crisis is the worst place to start building a relationship and that it is important to have built that relationship so when a crisis comes someone does pick up the phone to you and say if we are trying do this can you give us a bit of help with problem solving? And, again going back to my experience at an OECD meeting, there were those that took the view you don't want to be in the room because you will be blessing sin. I think that is quite an extreme position to take. To be credible you need to have a clear set of principles, articulate those principles well and help people find the right solutions, and competition advocacy plays a huge role in supporting competition policy in that case and a role that I think still needs to be built further.

MR MARSDEN: Thank you very much. There is nothing more demoralising in a marathon than finding out that a feed station is about two miles further away than you think it is. So, recognising that we are approaching lunch and will continue the discussion afterwards, I am going to take three more comments now.

MR McDOWELL: I was very interested in Edward and Susan's paper. Just to focus our attention again, we are talking here at this meeting about regulation and competition, and perhaps not doing full justice to Edward's paper. I could say okay, we can summarise this as saying "look, you have the financial crisis, this can be thought of as a consequence of a lot of competition in a market where there is a lot of market failure full stop". In a sense that is what we are talking about, and the solution to this is to deal with the instance of market failure. The danger I see in this is that there is also a tendency I think to water down competition. Now, first principles in economics tells us that what we should be doing is concentrating on the incidences of market failure, and it is only in the circumstances that we can't correct those that you can make a case for curbing competition.

Looking at this, the diagnosis here is a set of markets which have systemic market failure effectively due to bounded rationality on the part of everybody in the market. I think there is a case for arguing there is bounded rationality in some parts of the market, but there is also something else going on which is that in fact agents in the market were being super rational because they took the view that they could borrow, they were being told they could. They knew very well

they could hand back the keys if things went wrong. The people who were lending them money took the view they could securitise it and pass on the loan. In other words, what we were dealing with here is simply moral hazard, which I am fond of saying is not something that happens at a disco to your daughter but is something which is simply a consequence of information, a symmetry. So it is a moral hazard problem we are dealing with here, it is not, I think, in most cases bounded rationality.

I think your very perceptive comment in this that the issue that the rating agencies had a lot to do with this, this is a genuine case of bound irrationality.

People were looking at what was going on in terms of classical statistical inference, where all events are independent, rather than thinking in terms of "one mortgage goes, all mortgages go" so in effect the standard models being used or being applied were not the correct models.

So, just to summarise on this, I would be inclined to think of this as a moral hazard problem rather than a simple bounded rationality thing to a large extent and in that case where does it come, and in fact it all comes from the deregulation in the 1980s and the unpleasant thought that what we may be looking at here is the deregulation of the financial markets in the 1980s which broke down barriers between them, created these opportunities for moral hazard, and what we should be trying to do is in effect replace that through regulation and simultaneously to make sure we maintain vigorous competition in regulated markets because in the absence of that we are just creating rents.

MR STUCKE: I will take the opposite position on this.

I very much enjoyed Ted's paper. What it brought to mind was the recent happiness economic literature by Daniel Kahneman and Richard Layard, among others. This research builds on Adam Smith's Theory of Moral Sentiments and the work by Thorsten Veblen and John Kenneth Galbraith. One issue is how good are individuals in predicting what makes them happy? The financial crisis I believe brought this to the fore when you consider the increase in consumer debt as well as the negative personal savings rate. This, then, would go to Philippa's point as to what should be in the toolkit and then to Cavendish's point as to the timing. Do we need to have a better measure of utility than revealed preferences? For example, Professors Stiglitz, Sen and Fitoussi have chaired a commission that considered the limits of GDP as an indicator of a country's economic performance and social progress.[4] Their recent report considers other indicators of social progress, including measures of subjective happiness.

[4] Report by the Commission on the Measurement of Economic Performance and Social Progress (2009), available at http://www.stiglitz-sen-fitoussi.fr (accessed on 31 January 2010).

From an Orwellian perspective, a governmental happiness committee is scary. On the other hand, is it realistic for economists and policymakers today to say that people know what makes them happy when they see this train wreck happening miles in advance? Is it irresponsible for the government, not so much telling people what makes them happy but promoting policies that may promote misery? If the government endorses increased output as invariably good or wealth as a measure of success or self-worth, is the government then acting as cheerleaders to an ensuing problem?

MR JANGER: Some very quick, I think pointed, responses to those really excellent observations. To Isolde, I think your comment about the knee-jerk response, I think you're right, but I think one of the things that is difficult in a crisis situation is to distinguish between a knee-jerk response to a crisis and we told you so, which is to say one of the things a crisis gives you the opportunity to do is to say let's learn from history what are the lessons, what should we have seen coming, how would we want to live our lives differently going forward. Those aren't things that go to the immediate crisis response, which is to say how do we get banks lending money again, but how do we recondition our markets so that we identify the problems that aren't the one timers, the one-offs that will go away because the market figures that out. It is just your heuristic, it is tricky to distinguish those, but I think it is an exercise that's worth doing.

To Cavendish, sort of a similar point, which is one of the things that drives me a little bit crazy, and I note it in the paper itself, is the way the word competition gets used instrumentally in the policy debate by people who are engaged in special pleading. I am going to be very blunt here, competition gets teed up as "you are going to interfere in our ability to take advantage of consumers". I would much rather listen to a competition authority telling me what the competition policy is than a banker telling me that a particular regulation is going to lead to less product diversity.

As to the moral hazard problem, I think that is certainly an issue. I think you have to make a real distinction and an empirical distinction on the moral hazard problem between commercial borrowing and consumer borrowing and ask yourself a real empirical question about whether the focus of rationality is on the lend side or on the borrow side? There is a big consumer debate, bankruptcy debate, within the United States. We don't have a social safety net, we have bankruptcy, so you run up too much debt on flat screen TVs and then you file for bankruptcy, and the theory was that is just moral hazard, we are letting people walk away from their consumption decisions. There is by now a very large literature in the United States that shows that when people file, if you really look, I mean certainly they are going into bankruptcy more leveraged and less economically robust than they used to, but the things that trigger the

bankruptcies are not oh, I am walking away from my debt because I don't want it anymore.

People do all kinds of extraordinary things on an individual level to stay out of bankruptcy that are colossally irrational, that often lead them to lever up even more, for example converting dischargeable credit card debt into non-dischargeable home mortgage debt to refinance, and then you end up losing your house rather than filing for bankruptcy with this much debt. So I think the moral hazard story on the consumer side is pretty problematic.

On the commercial side everyone was socialising risk, so I think you have got to look at it on both sides, but I think you have to pull that story apart a little bit more. As to Maurice's point, I just agree.

MR MARSDEN: Thanks very much. I have good news, bad news and then more good news. The good news is that in marathion terms you have made it to "The Wall", at the 20 mile marker. The bad news is that in a 26.2 mile marathon this is really only the halfway point. The good news, though, is that we have some fuel outside for you and a fantastic final panel coming up. I hope you can stay with us and let's go to the next feed station. Thank you very much.