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Interplay between prudential requirements and competition law in the banking sector

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What a great journey this was. Time for a new one.

Abstract

Banks are usually founded in the form of limited liability companies. This creates an inherent structural issue due to the very nature of banking. As banks are formed as limited liability companies, their general objective is to make a profit for their investors. This fundamental characteristic of a limited liability company incentivizes banks to leverage themselves to increase their ROE and profits. However, if a bank is overleveraged, the default of a bank has wide implications to the whole economy due to interconnectedness of banks in all other business activities.

For this reason, prudential requirements have been imposed on banks to regulate their risk taking and that banks have enough capital to survive sudden losses. From a rather simple instruments to more intricate ways to regulate capital requirements, prudential requirements have evolved over time as a result of various financial crises where the shortcomings of those instruments have been noticed and then updated.

Given the strict nature of prudential requirements, those rules heavily influence how banks are able to conduct business in the banking sector. Without prudential requirements, banks would be free to compete with one another and to disregard any capital requirements normally imposed on them. However, the inherent structural problem of banks (e.g. limited liability of shareholders, incentive to over leverage etc.) prevents the scenario where banks could be left alone from a regulatory standpoint and compete freely.

This paper assesses the dynamic between prudential requirements and competition law. As prudential requirements seem to impose strict rules on banks and thus hinder competition, competition law, on the other hand, ultimately focuses on ensuring that competition is undistorted. This seemingly contradictory relationship invites assessing whether there is this “tug of war” between the two areas of law, or whether they live in harmony with one another.

Abbreviations

BCBS	Basel Committee on Banking Supervision
CJ	The Court of Justice
CRA	Credit rating agency
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
ECU	European Currency Units
EUMR	EU Merger Regulation
IRBA	Internal Ratings-Based Approach
LCR	Liquidity Coverage Ratio
M&A	Mergers and Acquisitions
NSFR	Net Stable Funding Ratio
ROE	Return on Equity
SA	Standardised Approach
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union

1. Introduction

1.1. Background

Banking is a rather unique form of business activity. Very generally speaking, banks are engaged in two opposing lines of business activity: buying and lending money. Firstly, banks "buy" money from the public in the form of deposits. People deposit their money in a bank and the bank pays a small interest for that deposit. The interest is based on the amount and maturity of the deposit. Typically, the longer the maturity of the deposit, the higher the interest will be. Secondly, banks lend out the money in the form of credit (debt). By lending out money, the borrower is charged an interest rate which is profit for the bank. Thus, a bank acts as a sort of intermediary to those wishing to deposit or to loan money. The position of an intermediary is ultimately built upon trust.

Banking and the introduction of credit revolutionised the economy. In all of its simplicity, spending drives the economy and spending is directly linked to productivity. In essence, productivity concerns how much can you produce and sell goods or services. Therefore, historically, the economy grew only when productivity was increased. This resulted from the fact that increased productivity results in increased spending. By, for example, purchasing better tools, hiring more work force or inventing new machines, you were able to increase your productivity. This resulted in economic growth, although the growth being rather slow due to physical restraints relating to work force and new machines. However, when the credit system was introduced, the amount of money available in the market increased. Banks were suddenly able to create "new money" when they gave out loans to the public. The creation of this new money increased spending, and as spending increased, so did the overall economy.

However, there is an inherent problem with lending and credit due to the nature of banks and how they do business. Banks are typically founded in the form of a limited liability company. A limited liability company is a legal person distinct from its shareholders and, thus, its shareholders have no personal liability for the obligations of the company.[1] This fundamental characteristic of limited liability companies creates one of the inherent concerns in banking: if banks operate as limited liability companies and their capital requirements are not regulated, limited liability creates a structural issue. What is this structural issue, and why does it matter?

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[1] In example, the Finnish Limited Liability Companies Act (624/2006), Chapter 1, Section 2.

As banks are businesses and their purpose is to generate profits for its shareholders[2], banks have the incentive to acquire (even excessive amounts of) borrowed capital instead of relying merely on their own equity. By having more capital, a bank is able to acquire assets generating interests which, in turn, will lead to increased profits in the form of dividends to its shareholders, this being the perfect case scenario. If the bank defaults, the shareholders are shielded from any liability and their losses remain the same (the invested capital) no matter the amount of risk the bank has taken. Let us think about a concrete situation to illustrate this effect of limited liability.

Two new banks are founded in the form of limited liability companies. Both banks' share capital is €1 million. Bank A takes an aggressive approach. It borrows as much money as it can from the market. In the end, bank A ends up getting €19 million of debt capital. Bank B takes a more cautious approach: it only borrows €9 million from the market. Now, with their newly raised capital, both banks invest in similar assets. The assets pay out an interest of four (4) percent every year. Both banks have a similar cost structure and each year their operating costs amount to €100,000. Now, after the first year, bank A has made a total profit of €700,000 and bank B €300,000. The return on equity (ROE) for bank A is 70% and for bank B 30%.

	Bank A	**Bank B**
Share Capital	€1 million	€1 million
Borrowed Capital	€19 million	€9 million
TOTAL CAPITAL INVESTED	*€20 million*	*€10 million*
Yearly interest from acquired Assets	4%	4%
Operating Costs	€100,000	€100,000
TOTAL PROFIT	*€700,000*	*€300,000*
ROE	70%	30%

Table 1: Example in a table format.

What we can observe from this example is that due to leverage, bank A's shareholders have a much higher upside compared to bank B's shareholders. Bank A's shareholders receive much higher ROE with the same invested

[2] ibid, Chapter 1, Section 5.

capital compared to bank B's shareholders. However, leverage is dangerous if it is abused, as we can witness from the following example.

Let us assume that the assets of both bank A and B have the same amount of risk, and they will incur similar losses (percentage) in the event that the value of the assets decrease. Let us imagine that next year, both banks have to write off their assets by five (5) percent due to depreciation. Because of the write-off, bank A incurred a loss of €1 million It has now lost its equity and its assets are worth less than its liabilities. If bank A enters liquidation and its assets are sold to pay off its liabilities, bank A's creditors would definitely incur a loss. On the other hand, bank B's total losses would only amount to €500,000 meaning that bank B still has €500,000 of its equity left. If liquidated, bank B's creditors would not lose their borrowed capital, unlike bank A's creditors.

The key takeaway from the examples presented above is that leverage matters. The limited liability shields shareholders, as they will only lose their invested capital if the bank defaults, no matter how leveraged the bank is. On the other hand, the creditors might be in a much more dire situation, depending on the debt-to-equity ratio of a bank. If the bank is heavily leveraged and the debt-to-equity ratio is high (like in bank A's situation), it is unlikely that the creditors will get their money back in full as the equity of the bank is not enough to cover all of its liabilities in the event of a default. That is why it can be stated that *equity* acts as a shield that protects creditors from potential losses of the debtor.

In theory, the creditors and shareholders of a bank should prevent the accumulation of excess leverage. Rational investors demand higher profits for high risk investments. Similarly, rational investors expect lower profits for lower risk investments. The underlying value of a company is thus unaffected by how that company is financed. This is the so-called Modigliani-Miller theorem.[3] However, the Modigliani-Miller theorem does not fully apply to banks for the following three reasons.

Firstly, banks' balance sheets are typically opaque and the information available between banks and creditors is asymmetric.[4] As banks know more about their balance sheet than any third party, creditors and especially depositors are unable to effectively monitor the amount of risk a bank has accumulated. For investors, this leads to underestimating the bank's risks and financing the bank too cheaply.

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[3] Franco Modigliani and Merton H Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48 The American Economic Review 261.

[4] Mika Viljanen, *Baselin pankkisääntelystrategiat* (Painosalama Oy 2015) 30.

Secondly, explicit and implicit government guarantees alter the interests of creditors to monitor banks.[5] As deposits are typically protected under deposit protection schemes, the amount of risk in a bank's balance sheet does not affect the interest depositors demand from a bank (explicit guarantees). Implicit guarantees have the same type of effect if banks are regarded as "too big to fail". Creditors will finance a bank in the hopes that the government will bail out the bank if it defaults.

Thirdly, a tax shield enables banks to deduct the interests it pays out from its profits, resulting in a lower overall amount of tax owed to the government.[6] Tax shield lowers the "price" of borrowed capital compared to capital financed by equity.

For these aforementioned three reasons, banks seek to and are able to leverage themselves to an extent that their balance sheets hold too much debt compared to equity. Since the Modigliani-Miller theorem does not fully apply to banking activity, banks cannot be effectively monitored under "normal circumstances" due to the structural issues mentioned above. That is why banks are being regulated in order to ensure the proper functioning of the market economy.

In economic theory, regulating the banking sector has been justified by the need to prevent such external events from damaging banks and minimizing the effects of a major banking crisis can have on the wider economy.[7] Prudential requirements are one of the most central and important methods of regulating banks.[8] The basic idea of prudential requirements is rather simple: prudential requirements impose capital requirements on banks that they need to set aside enough capital to cover unexpected losses and to keep themselves solvent during a crisis. In addition to imposing capital requirements, prudential regulation may also concern liquidity requirements on banks.[9]

Prudential requirements heavily influence how banks are able to conduct business in the banking sector. Without prudential requirements, banks would be free to compete with one another and to disregard any capital requirements normally imposed on them. However, as discussed above, the problems related to banks being limited liability companies (e.g. limited liability of shareholders, incentive to highly leverage itself etc.) prevents the scenario where banks could be left alone from a regulatory

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[5] Viljanen (n 4).

[6] ibid 30–31.

[7] Andreas Busch, *Banking Regulation and Globalization* (Oxford University Press 2009) 25.

[8] Viljanen (n 4) 27.

[9] Charles HR Morris, *Law of Financial Services Groups* (First edition, Oxford University Press 2019) 57.

standpoint and compete freely. This dynamic displays an interesting question: what is the interplay between prudential requirements and competition law?

1.2. Research Question and Delimitation

This thesis goes into detail to analyse what is the interplay between prudential requirements and competition law. The underlying argument of this thesis is that prudential requirements and competition law are in a state of "tug of war" where prudential requirements set strict boundaries on how banks may operate and compete in the market economy, while competition law incentivises a market economy that is driven by free competition. This relationship also brings out the question that should we, as a society, favour free competition or financial stability, and to which extent are we willing to restrict or protect these two important elements of the modern market economy.

The main focus of this thesis will be Europe, and more specifically the EU. However, given the global nature of the banking, international rules and regulations (mainly Basel) will be analysed as they also form a basis for the regulations in Europe. Furthermore, given the historical importance of the United States' market, it will also be analysed and compared to what has happened and what is currently happening in Europe in terms of prudential requirements and competition.

1.3. Method

This thesis follows mainly the legal-dogmatic method (legal doctrine). Law and economics approach is also used, although to a lesser degree, to assist the effects of different policies in the economy. While the legal doctrinal approach does not have one definition that has been set into stone, it can be stated that the research aims to give a systematic exposition of the principles, rules and concepts governing a certain legal field and to analyse the relationship between these principles, rules and concepts with the intent to solve ambiguities and gaps in already existing law.[10] The aims of legal doctrine can be divided into three main goals: 1) describing existing law (description), 2) search of practical solutions fitting the existing system (prescription), and 3) serve as a justification for the existing law (justification).[11]

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[10] Jan M Smits, 'What Is Legal Doctrine? On the Aims and Methods of Legal-Dogmatic Research' (Social Science Research Network 2015) 5.
[11] ibid 8–11.

Law and economics, on the other hand, originates from the common law system but holds its place also in the civil law legal analysis. In the law and economics approach, the tools of economic analysis are being used to produce new insights and research regarding legal subject matter.[12]

This thesis will follow both of these approaches, but the main emphasis will be on legal doctrine. While legal doctrine gives essential "tools" to systematically analyse the interplay between prudential requirements and competition law, it would not be enough given the inherent economic nature of the banking sector. Law and economics help out on that front to provide an economic viewpoint to the said interplay. Together, these two approaches complement each other in giving a comprehensive analysis of the interplay between prudential requirements and competition law.

1.4. Structure

This thesis is divided into three main parts: overview and history of the regulation in the banking sector, relationship between prudential requirements and competition law, and assessment of stability and competition.

In the overview and history of banking regulation, the primary focus of the chapter is to give the reader an understanding why special regulation exists in the banking sector. First, the rationale for regulation and the different instruments are looked at to understand the underlying reasons why prudential requirements exist. Then, the history of prudential requirements is looked at to understand the developments banking regulation has gone through throughout the years. Finally, the current legislative landscape will be covered to have an up-to-date understanding of how banks are currently regulated in the EU.

After the overview and history of banking regulation, the attention turns to the relationship between prudential requirements and competition law, namely how competition is prevalent in the banking sector and what kind of objectives do the two areas of law pursue. Given the special nature of banking and banking regulation, it is important to assess the possible similarities and differences in not only objectives , but also how competition affects the banking sector in the EU.

Finally, the interplay between prudential requirements and competition law culminates in the assessment of how stability and competition affects one another. The chapter analyses whether the proposed

[12] Richard A Posner and Francesco Parisi (eds), *Law and Economics* (Edward Elgar Pub 1997).

argument of the "tug of war" between prudential requirements and competition law holds water, or whether that argument needs a revision based on the assessments made.

2. Regulation in the Banking Sector

2.1. Rationale for Regulation and Instruments

Banks have become essential players in the economic life of every modern society. The banking system plays a crucial role in the functioning of every business as well as in the everyday life of most people.[13] The significance of the banking system can be boiled down to two factors: 1) banks provide all other parts of an economy as well as the consumers on which all businesses depend with credit, and 2) the banking sector is one of the most vulnerable parts of the modern economic system.[14]

The collapse of a bank has much wider and deeper impact on the economy compared to the failures occurring in the other parts of the economy. If we think about a "normal" failure, the bankruptcy of a single company usually benefits the other players in the specific market. This is due to the fact that the competitors are able to take over the customer base of the failed company. This, in turn, does not harm the economy as much as other market players fill the gap left by the failed company.

The failure of a bank is another matter in its entirety. The collapse of a bank can seriously damage its competitors and the whole economy. One of the reasons for this is that the banking sector is highly interconnected.[15] Banks have substantial portfolio overlap of exposures to the financial sector, meaning that banks are exposed to similar assets that are liabilities of other financial institutions.[16] Furthermore, banks have a high degree of portfolio overlap of leveraged exposures, meaning that an idiosyncratic shock could have a widespread impact on banks' balance sheets.[17] Because there is significant systematic importance with financial linkages, the systemic risk of interconnectedness between banks and the consequences of the

[13] Busch (n 7) 23.
[14] ibid.
[15] Alan Roncoroni and others, 'Interconnected Banks and Systemically Important Exposures' (2021) 133 Journal of Economic Dynamics and Control 104266, 1.
[16] ibid 1–2.
[17] Roncoroni and others (n 15).

bankruptcy of a large bank are a cause of worry if not properly addressed with regulation.

If we think about the rationale for regulation in concrete terms, we need to consider the core function performed by banks: accepting and taking deposits and giving out loans. For banks, deposits are a form of short-term liability, as they are withdrawable by demand.[18] Under normal circumstances, banks hold only a fractional amount of the total value of the deposits and use the remaining part to make loans. By giving out loans, a bank charges higher interest to their borrowers than what it pays out to its depositors. This is profit for the bank. However, there is an issue with this relationship between deposits and loans: as deposits are short-term liabilities and loans usually have longer maturity, this creates a so-called maturity mismatch.[19] During good economic times, this business model functions efficiently and in a way that it is meant to. However, during bad economic times, that is not necessarily what happens. Banks' reserves that have not been used to make loans and which have been invested in liquid assets, might not be enough to meet the depositors' withdrawals in the event that a flock of people decide to take their money out. If the situation deteriorates quickly, a bank might be faced with a bank run.

A bank run occurs when depositors rush to withdraw their deposits from the bank because they expect the bank to go insolvent.[20] This sudden surge in withdrawals may force the bank to liquidate many of its assets at a loss and fail as a result.[21] A bank may not be able to keep up with the withdrawal rate as the loans the bank has given have a long maturity, and they cannot be turned into cash in an instant. The problem with bank runs is that, in essence, a bank run feeds on itself. What this means is that once the first depositors withdraw their deposits from the bank in the fear of the bank going bankrupt, they are able to withdraw their deposits without a problem. However, as the words starts to spread that depositors are withdrawing their money from this bank, another batch of depositors might get spooked, and they also withdraw their deposits. This repeats and soon enough the bank has run out of its liquid reserves and cannot execute the continuing withdrawals.

Regulations have been put in place to prevent bank runs from contributing to the collapse of banks. Primarily, capital is used to face the

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[18] Marco Bodellini, 'The Long "Journey" of Banks from Basel I to Basel IV: Has the Banking System Become More Sound and Resilient than It Used to Be?' (2019) 20 ERA Forum 81, 83.

[19] ibid.

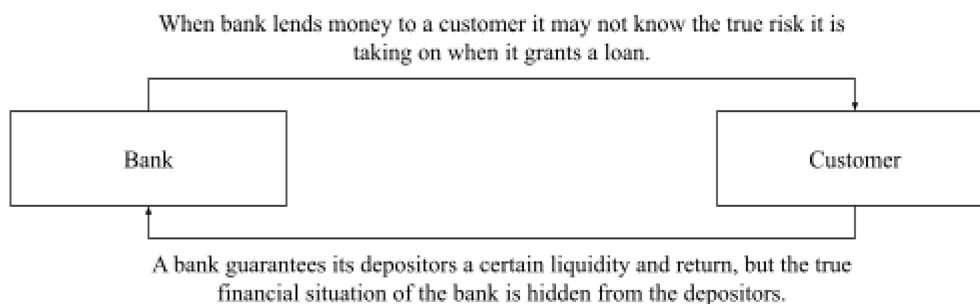
[20] Douglas W Diamond and Philip H Dybvig, 'Bank Runs, Deposit Insurance, and Liquidity' (1983) 91 Journal of Political Economy 401, 14.

[21] ibid.

risk of maturity mismatch. If a bank is undercapitalised, it is more vulnerable to the mismatch and, therefore, bank runs.[22] Thus, if a bank holds a proportionally significant amount of capital, it may be capable of absorbing possible losses. And if the losses are effectively absorbed, the bank's depositors should be less inclined to withdraw their deposits as the bank's financial health is backed by the capital itself.[23]

While banks play an important role in the modern economy, is it actually warranted that the banking sector requires special regulation? While it is logical to think that an important sector of the economy might need special regulation, what are the key rationales behind the special regulation concerning the banking sector?

The short and sweet answer is the banking sector needs special regulation because the financial markets are not complete and that market failures occur. The asymmetric information problem between suppliers and customers of financial services is one of the reasons why banks are governed by special regulation.[24] This asymmetric information problem is two-fold[25], as illustrated by Graph 1.



Graph 1

While the asymmetric information problem is not unique to the banking sector, it poses more far-reaching consequences compared to other sectors of business.[26] Yet, there are possible ways to solve this problem. First, the more secure banks could offer less favourable conditions to their customers compared to less secure banks.[27] Second, a bank having a reputation for good management and solvency acts as a kind of guarantee to depositors

[22] Bodellini (n 18) 83.
[23] ibid 84.
[24] Jordi Canals, 'Universal Banks, Specialized Banks and the Regulation of Financial Services', *Universal Banking* (Oxford University Press 1997) 307.
[25] Canals (n 24).
[26] ibid.
[27] ibid.

and shareholders that the bank's risk level is low or, at least, below average.[28]

In other sectors, the to methods of variable conditions for services and reputation have shown to reduce and limit the asymmetric information problem, as showcased by a study conducted by Shapiro. In his findings, Shapiro stated the following: "This paper has investigated the implications of reputation in a perfectly competitive environment. It has been shown that reputation can operate only imperfectly as a mechanism for assuring quality. High quality items sell for a premium above cost. This premium provides a flow of profits that compensate the seller for the resources expended in building up the reputation."[29] However, despite Shapiro's findings, these mechanisms are not very practical in the banking industry. The first solution would prevent a bank that is more effective from offering better conditions than a less effective bank.[30] The second solution, on the other hand, is not suitable either, as it is very difficult to develop reputation in the short term and bad decisions may plummet or hurt the reputation.[31]

What we can observe is that the asymmetric information problem is particularly acute in the banking sector. This is highlighted by the fact that solutions that have worked in other industries do not really apply to the banking sector due to its unique nature.

The second factor relating to the need for special regulation concerns the contradiction between growth and solvency in the banking sector.[32] What does this mean? A bank traditionally grows in two ways: 1) by attracting more deposits, or 2) giving out more loans. Either type of growth might be a cause of financial innovation or having more favourable conditions for savers. This growth, however, might lead to a decrease in the bank's financial margin which, in turn, lowers operating results.[33]

As banks compete for capital with other non-financial companies on the stock market, banks need to return prospects comparable to those offered by other companies in order to raise capital.[34] The problem is that those prospects may not be very favourable if there are no, or very few, growth opportunities. This is where banking regulation steps in: it controls and moderates banks' incentive for excessive risk taking in the name of growth to gain greater short-term return for their shareholders.[35]

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[28] ibid.
[29] Carl Shapiro, 'Premiums for High Quality Products as Returns to Reputations' (1983) 98 The Quarterly Journal of Economics 659, 678.
[30] Canals (n 24) 307.
[31] ibid.
[32] ibid 308.
[33] ibid.
[34] ibid.
[35] ibid.

The third factor relates to deposit guarantees: as the deposits in banks and other financial organisations are insured by deposit guarantees in many countries, banks may be induced to take on excessive risk, knowing that there is a safety net in place for them that will prevent bankruptcy if the risks are not sustainable.[36]

Finally, banks typically have a lower ratio between equity and external resources than companies in other sectors.[37] In other words, banks rely more on borrowed capital than on their own equity. This lower ratio of equity to external capital implies that the risks of banks are clearly greater to companies whose ratio is higher. For this reason, banks have been imposed with higher capital requirements, or prudential regulation preventing them from taking on excessive risks.[38]

These special characteristics have led to governments intervening and regulating banks due to their unique nature compared to other types of businesses. Three policy goals of banking regulation are of particular importance and are contained in any model of regulation: 1) ensuring a country's financial stability, 2) ensuring banks' solvency and profitability as a necessary measure for guaranteeing financial stability (prevention of systematic risk), 3) protecting banks' depositors and investors from the losses caused by malpractice in the activities performed by the bank, or by excessive risk-taking.[39] In addition to these three goals, a fourth goal can be identified: the promotion of competition.[40] Therefore, the three core policy goals are designed to favour competition in the sector, prevent the formation of oligopolies or the implementation of oligopolistic practices, and promoting maximum efficiency in the allocation of financial resources.[41]

Governments have used various methods to achieve these goals (e.g. the partial or complete nationalization of the banking system, intervention in the credit allocation process through legislative or administrative mechanisms, or the reduction of systemic risk through the introduction of a legally enforceable separation of commercial banks from their investment banks) and the approaches taken vary from one country to another.[42] The next two chapters go into detail how banking has been regulated in the past, how the whole banking sector has changed and what has been the impact on regulation, and what is the current legislative landscape like.

[36] ibid.
[37] ibid.
[38] ibid.
[39] ibid 311.
[40] ibid.
[41] ibid.
[42] Busch (n 7) 26–27.

2.2. A Short History of Banking Regulation

Banking regulation is a global phenomenon, being multipolar and consisting of multiple different levels. Banking regulation is nowadays global, regional and national, all at the same time. This, however, was not always the case. Let us look into a "short" history of banking regulation to understand what came before the current set of rules and regulations.

It is important to note that banking regulation has not followed a clear master plan towards some clear-cut goal(s), but instead the development of banking regulation has responded to the various financial crises, and scandals that have occurred during the modern age of banking.[43]

Before the 1970s-80s, banking regulation was rather rudimentary and not very sophisticated. National banks were in a tight lease of the central bank, as the central bank could heavily influence to whom and what the banks could finance. From an international perspective, the outlook on baking regulation was rather confusing. Despite the regulation being rather simple, the different instruments used throughout the various economies created a confusing overall picture of the whole European banking sector. For example, in Finland the formal banking regulation relied upon reserve requirements and very simple prudential requirements, whereas in Sweden, France, Great Britain and Germany the prudential requirements took into account the risk levels related to the balance sheets of the banks. The legislation in Finland did not take into account any risk-based assessment regarding prudential requirements.[44]

What was also concerning was the way that capital was regulated in Europe. The regulations were, again, not coherent between various countries and the ratio of capital that the banks were holding had been dropping for quite some time.[45] This naturally meant that banks were vulnerable to banks runs and meltdowns. This was not just a national or a European problem, it was a global one.

A significant blow to the international banking system occurred in 1974 which sparked the legislative process to harmonise banking regulation and prudential requirements. A bank called Herstatt was a rather small bank in Germany, but it had important international connections due to its foreign exchange trading.[46] On 26 June 1974, the German banking supervisory

[43] Jerry W Markham, 'Banking Regulation: Its History and Future' (2000) 4 N.C. Banking Inst. 67, 221.
[44] Viljanen (n 4) 51.
[45] ibid.
[46] Emmanuel Mourlon-Druol, '"Trust Is Good, Control Is Better": The 1974 Herstatt Bank Crisis and Its Implications for International Regulatory Reform' (2015) 57 Business History 311.

authority closed the Herstatt bank due to heavy losses it had endured as a result of speculative foreign exchange positions it had taken.[47] The foreign exchange dealers had sold a sizeable portion of US dollars against the Deutsche Mark, but the market moved against them. The German authorities closed the bank in the middle of the day. At this point in time, the United States markets had not yet opened. By the time the authorities had closed the bank, Herstatt had received the marks it had bought two days ago earlier, but because of the time zone difference, the bank had not yet delivered the dollars it had sold.[48] The United States intermediary of Herstatt that was supposed to deliver the dollars found itself in a tricky situation: if it paid the opposing side of Herstatt's deal, it would never get its money from the bankruptcy estate of Herstatt. On the other hand, if the intermediary did not pay the dollars to the opposing side of Herstatt's deal, it would not incur losses itself. With this scenario looming over its head, the intermediary decided not pay the opposing side the dollars like it was supposed to do. Chaos ensued. Banks in the United States were missing dollars that they were supposed to have received under normal circumstances. As a result, those banks could not conclude their own transactions due to the lack of dollars in their possession. This, in turn, lead to defaults. As a result, the United States exchange market froze up and multiple banks almost went bankrupt as a result.[49]

2.2.1. The Basel Committee on Banking Supervision

The bankruptcy of the Herstatt bank was a wakeup call to the international community. The Bretton-Woods system had also come to the end of its road when the international monetary system ceased to exist in 1973.[50] Soon after the Herstatt crisis, the Basel Committee (initially named the Committee on Banking Regulations and Supervisory Practices) was established by the central bank Governors of the Group of Ten countries at the end of 1974.[51] The mission of the Committee was rather simple: "to enhance the financial stability by improving the quality of banking supervision worldwide, and to

[47] 'Financial Stability Review December 2007' European Central Bank 242, 149.
[48] ibid.
[49] Viljanen (n 4) 51.
[50] Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System - Third Edition* (Princeton University Press 2019) 124 <http://www.jstor.org/stable/10.2307/j.ctvd58rxg> accessed 3 April 2022.
[51] 'History of the Basel Committee' <https://www.bis.org/bcbs/history.htm> accessed 3 April 2022.

serve as a forum for regular co–operation between its member countries on banking supervision."[52]

The Basel Committee on Banking Supervision (BCBS) is a rather special type of organisation: it does not have any supranational status, but rather it is just a forum of experts who get together with the purpose to enhance the effectiveness of banking regulation.[53] The Committee has mainly created standards or soft-law principles that have then been transposed into national regulations, thereby becoming bindings rules.[54] Even though the BCBS's standards are not directly applicable nor do they have legal binding force, the BCBS has still become a *de facto* international regulatory body.[55]

The BCBS took its first step into becoming the *de facto* international regulatory body in 1988 when Basel I[56] was adopted. The Basel I had a big impact as prior to its adoption there were no international standards on bank capital to apply to internationally active institutions. In the introduction of Basel I, two fundamental objectives were laid down by the BCBS: 1) that the new framework should serve to strengthen the soundness and stability of the international banking system, and 2) that the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks.[57]

What is important about the Basel I is that it was specifically adopted to set *minimum levels* of capital for internationally active banks.[58] National authorities were free to adopt arrangements that set higher levels, but the capital levels imposed in Basel I were the bare minimum that were seen as acceptable by the BCBS. The problem of falling capital levels had clearly been recognized at BCBS, and Basel I responded to that problem by introducing the minimum capital levels to be followed by internationally active banks.

Basel I had a rather simple structure. It introduced the concept of risk-weighted assets, and a general rule that the minimum amount of regulatory capital had to be at least 8% of the risk-weighted assets (a target standard ratio). The framework of weights included only five weights: 0, 10, 20, 50 and 100%.[59] The weighting structure was set as follows: Group 1

[52] ibid.
[53] Bodellini (n 18) 85.
[54] ibid.
[55] ibid.
[56] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards (Basel I)* (1988).
[57] ibid 1.
[58] ibid 2.
[59] ibid 8.

included e.g. cash, claims on central governments and central banks and other claims on OECD central governments and central banks, Group 2 included e.g. claims on multilateral development banks and claims on banks incorporated in the OECD, loans guaranteed by OECD incorporated banks and cash items in process of allocation, Group 3 included loans fully secured by mortgage on residential property, and Group 4 included e.g. claims on the private sector, claims on banks incorporated outside the OECD with residual maturity of over one year and all other assets. The BCBS had assigned each group with its own risk weight: Group 1 had 0%, Group 2 had 20%, Group 3 had 50%, and Group 4 had 100%.

The risk weightings were based on the assumption that the different assets that a bank has in its balance sheet typically carry varying levels of risk. Therefore, the amount of capital needed to hold was based on the bank's assets' riskiness. The higher the percentage, the riskier the assets in that group are. And the higher the percentage, the more capital a bank was required to hold.

As an example, a bank has a cash reserve of €500,000 and €100,000 as loans given out to different private companies. As we know from the weighting structure of Basel I, cash belongs to Group 1 meaning that it has a risk-weight of 0%. However, loans to private companies belong to Group 4 which have a risk-weight of 100%. We are now able to calculate the minimum capital requirement of the said bank. The risk-weighted assets as per the set norms will be as follows:

*= (€500,000*0) + (€100,000*1)*
= 0 + €100,000
= €100,000

The bank in question has to maintain a minimum of 8% of the €100,000 as a minimum capital (of which at least 4% has to be in tier 1 capital). The minimum amount of capital thus equals to €8,000.

While Basel I had a positive impact on increasing the amount of capital held by banks, it was not perfect. Basel I was shadowed by a number of shortcomings by e.g. lacking risk sensitivity and risk mitigation techniques.[60] Furthermore, market risk and operational risk were not taken into account either.[61]

Given the shortcomings of Basel I, the BCBS did not stand idle, but in June 1999 issued a proposal for a new capital adequacy framework to replace Basel I. This proposal eventually led to the release of a revised

[60] Bodellini (n 18) 87.
[61] ibid.

capital framework in June 2004, “Basel II”.[62] Compared to Basel I, Basel II was a much more detailed document that aimed to fix the shortcomings of Basel I. By merely looking at the number of pages, Basel I with a mere 30 pages is outclassed by Basel II that consists of more than 200 pages.

As mentioned, the fundamental objective of Basel II was to revise the Basel I by developing a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.[63] The revised framework had a three pillar approach: the first pillar was based on a revised minimum capital framework, the second pillar included a supervisory review process, and the third pillar concerned market discipline based on mandatory and voluntary disclosure.[64]

A significant change to Basel I was letting the banks use their own assessments of risk as input in capital calculations. In Basel I, banks could not determine the risk levels of the different assets on their own, as the risk levels were already set in the documentation of Basel I. Now in Basel II, the banks had at their disposal two broad methodologies for calculating their capital requirements for credit risk: 1) to measure credit risk in a standardised manner (Standardised Approach, SA), supported by external credit assessments, or 2) use banks’ internal ratings-based approach (IRBA) to calculate capital requirements, subject to the explicit approval of the banks’ supervisor.[65] Under IRBA, banks’ own internal models are used to estimate risk to be used as inputs in the risk weight functions defined by regulators.[66] Banks who then did not have the financial resources and data needed to obtain the approval for IRB models instead adopted the SA of Basel II.[67]

The second pillar was centred around the Supervisory Review Process (SREP) which consisted of four key principles: 1) banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels, 2) supervisors should review and evaluate banks’ internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios, 3) supervisors should expect banks to operate

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[62] ‘History of the Basel Committee’ (n 51).

[63] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards - A Revised Framework (Basel II)* (2004) § 4.

[64] Bodellini (n 18) 87.

[65] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards - A Revised Framework (Basel II)* (n 63) § 50-51.

[66] Matteo Benetton and others, ‘Capital Requirements and Mortgage Pricing: Evidence from Basel II’ (2021) 48 Journal of Financial Intermediation 100883, 4.

[67] ibid.

above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum, and 4) supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.[68]

The purpose of the SREP was not only to ensure that banks have adequate capital to support all the risks in their business, but to also encourage them to develop better risk management techniques in monitoring and managing their risks, and to ultimately use those techniques.[69] The BCBS had recognised the relationship between the amount of capital held by a bank against its risks and the strength and effectiveness of the bank's risk management and internal control processes, and introduced the second pillar to highlight the importance of supervisory review and to enhance the way banks assess their own risk profile and strategy.

The third pillar of Basel II concerned market discipline. The rationale behind the third pillar was to complement the minimum capital requirements (first pillar) and the supervisory review process (second pillar).[70] The BCBS aimed to encourage market discipline by developing a set of disclosure requirements which allowed market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and the capital adequacy of a bank.[71] The BCBS believed that the disclosures would have had particular relevance under Basel II, where the reliance on banks' internal methodologies gave them more discretion to assess capital requirements.[72]

Despite the changes and modifications made to Basel II, it was not a resounding success. For example, the significant change that banks were able to use their own assessments of risk as input in capital calculations could be described as a slight oversight from the BCBS. As banks were able to use their own risk assessments instead of the standardised approach, the banks knew their own situation better than the supervisors, which allowed them to significantly decrease the amount of capital held as supervisors often lacked internally the sophisticated skills and personnel to challenge the banks' internal models.[73] This can also be described as being an information asymmetry problem in another form, involving supervisors instead of

[68] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards - A Revised Framework (Basel II)* (n 63) § 725-760.
[69] ibid § 720.
[70] ibid § 809.
[71] ibid.
[72] ibid.
[73] Bodellini (n 18) 87.

depositors. Furthermore, the extensive and intensive impact of the 2008 global financial crisis showcased the various weaknesses of Basel II especially with regard to capital adequacy, capital buffers, risk coverage and liquidity.[74] Basel II gave a false sense of security and as a heavy emphasis was placed on credit rating agencies (CRAs), the final result was a catastrophe. Before the financial crisis, the three main ratings agencies in the United States (Moody's, Standard & Poor's and Fitch) gave triple A rating to securities whose quality was far lower than the given rating.[75] As Basel II relied on credit ratings to a great extent, when the ratings do not correspond to the actual risk levels one is faced with a serious problem.

At this point, it was pretty clear that Basel II had not achieved the goals it had set out to accomplish. A reform was badly needed. During the same month when Lehman Brothers failed in the United States, the BCBS issued a set of guidelines with principles for sound liquidity risk management and supervision.[76] The global financial crisis and the market turmoil that had begun in mid 2007 re-emphasised the importance of liquidity.[77] Given that a number of banks had failed to take into account the basic principles of liquidity risk management when liquidity was plentiful, the BCBS conducted a fundamental review of its 2000 guidance regarding "Sound Practices for Managing Liquidity in Banking Organisations" by issuing the new set of guidelines. This new set of guidelines provided detailed guidance on risk management and supervisions of funding liquidity risk. Ultimately, in 2010, the BCBS introduced the Basel III framework that extended the Basel II framework with several innovations and added liquidity requirements.[78]

Structurally, Basel III continued to use the Basel II framework of the three pillars (capital requirements, supervisory review and market discipline).[79] Basel III enhanced the liquidity framework of Basel II through two minimum standards for funding liquidity.[80] In order to promote short-term resilience of a bank's liquidity risk profile, the BCBS developed a Liquidity Coverage Ratio (LCR) to ensure that a bank has sufficient

[74] Peter Yeoh, 'Basel IV: International Bank Capital Regulation Solution or the Beginnings of a Solution?' (2018) 39 Business Law Review 176, 176.
[75] Claire A Hill, 'Why Did Rating Agencies Do Such A Bad Job Rating Subprime Securities?' (2009) 71 University of Pittsburgh Law Review 585.
[76] Basel Committee on Banking Supervision (ed), *Principles for Sound Liquidity Risk Management and Supervision* (Sept 2008, Bank for Internat Settlements 2008).
[77] ibid 1.
[78] Yeoh (n 74) 179.
[79] Emily Lee, 'The Soft Law Nature of Basel III and International Financial Regulations' (Social Science Research Network 2014) SSRN Scholarly Paper 2553666 4.
[80] Basel Committee on Banking Supervision and Bank for International Settlements, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Bank for International Settlements 2010) § 4.

high-quality liquid assets to survive a significant stress scenario lasting for one month.[81] Furthermore, to promote resilience over a longer time horizon, the Net Stable Funding Ratio (NSFR) was introduced to create additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis.[82]

Importantly, the BCBS also recognised that one of the reasons that the economic and financial crisis became so severe was because the banking sector in different countries had built up excessive on- and off-balance sheet leverage.[83] This increased leverage was accompanied by a gradual erosion of the level and quality of the capital base, and, at the same time, banks were holding insufficient liquidity buffers.[84] All of this resulted in the outcome that the banking system was incapable of absorbing the resulting systemic trading and credit losses. Interconnectedness of systemic institutions further amplified this effect. In the end, the public sector had to step in with unprecedented injections of liquidity, capital support and guarantees, exposing taxpayers to large losses.[85]

Given the harrowing results, the BCBS raised the resilience of the banking sector by strengthening the regulatory capital framework of Basel II and building on the three pillar framework.[86] Firstly, Basel III raised the quality, consistency and transparency of banks' capital base. This was done by increasing the Tier 1 capital ratio from 4% to 6%.[87] Furthermore, that capital should consist of at least 4.5% high-quality equity capital as well as a capital conservation buffer of 2.5%.[88]

Secondly, risk coverage was enhanced. The capital requirements for the trading book and complex securitisation exposures were raised, and a stressed value-at-risk capital requirement based on a continuous 12-month period of significant financial stress was introduced.[89] Furthermore, the standards of the second pillar supervisory review process were raised and the third pillar's disclosures were strengthened.[90]

Thirdly, the BCBS introduced a leverage ratio requirement that was intended to constrain leverage in the banking sector and introduce additional safeguards against model risk and measurements error by supplementing the

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[81] ibid.
[82] ibid.
[83] Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Bank for International Settlements 2011) § 4.
[84] ibid.
[85] ibid.
[86] ibid § 7.
[87] ibid § 50.
[88] ibid § 50 and 150.
[89] ibid § 12.
[90] ibid.

risk-based measure with a simple, transparent, independent measure of risk.[91]

Fourthly, Basel III introduced a number of measures that make banks more resilient to procyclical dynamics and raise resilience during good economic times.[92]

Lastly, Basel III addressed systemic risk and interconnectedness. The BCBS introduced several capital requirements to mitigate the risks arising from firm-level exposures among global financial institutions in helping to address systemic risk and interconnectedness. These include e.g. capital incentives for banks to use central counterparties for over-the-counter derivatives, and the introduction of liquidity requirements that penalise excessive reliance on the short term.[93]

A change was also made regarding CRAs: under Basel III banks were required to evaluate credit risk exposure on their own and not be reliant solely on the ratings provided by various CRAs.[94] Furthermore, the new framework removed incentives for ratings shopping by requiring banks to consistently apply the ratings of CRAs selected by national supervisors to eliminate conflicts of interest.[95]

Before Basel III came fully into effect, reforms to Basel III had been released at the end of 2017. According to the BCBS, these reforms aimed to complete the improvements introduced in Basel III. While the new measures were said to be just a revision of the Basel III rules in place, the significance of the impact the reforms had on banking institutions prompted that these new measures were labelled by the industry as "Basel IV".[96] The rationale behind the introduction of reforms to Basel III was the fact that the measures of Basel III were not seen as sufficient, as banks were still over-relying on their internal models for calculating risk-weighted assets.[97] To correct these concerns, Basel IV introduced a number of new provisions that will influence the calculation of risk-weighted assets and, as a consequence, affect the amount of regulatory capital banks will hold.[98]

[91] ibid § 16.
[92] ibid § 18.
[93] ibid § 33.
[94] Yeoh (n 74) 180.
[95] ibid.
[96] Bodellini (n 18) 90.
[97] ibid.
[98] ibid.

2.2.2. Banking regulation in Europe: legislative evolution

Like in many other industrialized countries, the banking sector in the EU went through a financial deregulation process that was also compounded with the creation of a single financial market. In the EU, the financial unification started in 1987 with the introduction of the First Banking Directive. In its preamble, the Directive called for the enactment of legal provisions that can be grouped into five categories: 1) rules abolishing barriers between Member States relating to banking services, 2) rules allowing credit institutions to freely establish branches in other Member States, 3) uniform rules regarding essential authorisation requirements, 4) uniform rules regarding essential supervisory standards, and 5) rules regarding uniform treatment of non-EU (EEC back then) credit institutions. The Directive applied to all credit institutions, both taking up and in the pursuit of such business activity.[99]

The Directive imposed a requirement that Member States needed to require credit institutions to obtain authorisation before commencing their activities (principle of home country supervision).[100] Certain minimum requirements were introduced for licensing and supervising credit institutions, and a system was put in place for licensing new banks. The licensing of new banks was based on two main criteria: 1) a minimum capital volume and an honest and experienced management team.[101] Furthermore, the Directive included principles for future harmonisation regarding banks' liquidity and solvency ratios.[102] Importantly, the freedom of establishment of branches was set out in the preamble of the Directive. Those credit institutions that had their head office in one of the Member States were exempt from any national authorisation requirement when setting up branches in other Member States.

While the First Banking Directive laid down the above-mentioned minimum requirements, many EU Member States had already put in place more stringent regulations than those minimum principles required by the Directive.[103] The result was that the rules between Member States still differed quite a bit, which naturally affected the way banks were able to conduct business between Member States. While EU banks had a basic right

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[99] First Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions 1977 Article 2(1).
[100] ibid Article 3(1).
[101] ibid Article 3.
[102] ibid Articles 6-7.
[103] Canals (n 24) 320.

to establish themselves in another EU country, the disparity of national regulations made it rather difficult to do cross-border business in practice.

This scenario changed as the European Commission adopted a new criterion for establishing the single financial market: the principle of mutual recognition. With the introduction of the principle of mutual recognition, it was no longer necessary to harmonise various national regulations, as the rules of Member States were recognised in other Member States. Under the First Banking Directive, credit institutions wishing to set up a branch in another Member State still had to be authorised by the banking authorities of the host country. In addition, the branch remained subject to supervision by the host country and to restriction in host country laws on the range of permitted activities.[104] These restrictions were abolished by the Second Banking Directive that came into force in 1989.

The objective of the Second Banking Directive was to create a truly internal market in banking.[105] While the Second Directive did not create a uniform body of banking regulation within the EU, it obligated each Member State to mutually recognise the laws of and licences from other Member States. The Second Directive permitted any credit institution authorised in a Member State to 1) establish branches in other Member States[106] and 2) to offer services freely throughout the EU to individuals and businesses[107]. Accordingly, credit institutions were entitled to operate under their home Member State licence (single banking licence) throughout the EU. The provision of specific banking services could have conducted either by a bank acting by themselves or through a branch, which a bank could have established anywhere in the EU. Here it is important to note that this single licence was not a “federal” banking licence, so to speak.[108] Compared to the United States where the banking market consists of a single state, the principle of mutual recognition gave credit institutions access to all Member States, creating an inter-Member State banking market.[109]

However, it must be noted that the home Member State licence required by the Second Directive is limited to certain, specified banking activities. The Annex to the Second Directive lists the activities that are

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[104] Michael Gruson and Werner Nikowitz, ‘The Second Banking Directive of the European Economic Community and Its Importance for Non-EEC Banks’ 39, 210.

[105] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC 1989 Preamble.

[106] ibid Article 6(1).

[107] ibid Article 18(1).

[108] Gruson and Nikowitz (n 104) 213.

[109] ibid.

subject to mutual recognition. The licence was valid in other Member States only with respect to the activities specified in that Annex.[110]

The Second Directive also set guidelines in two specific areas relating to the creation of banks. Firstly, the Second Directive established a minimum volume of capital, which was set at five (5) million European Currency Units (ECU) for each bank.[111] Secondly, the Second Directive allowed a bank from a non-EU country to establish a subsidiary in an EU Member State and, from that EU Member State, open branches in other Member States. Importantly, however, the Member States could object to this by arguing that a bank's home country (third country) does not give the same treatment to its banks established in that country. In these scenarios, before a bank from a third country establishes itself in a Member State, the Commission will compile a report whether the third country gives reciprocal treatment to every Member State before granting the licence.[112]

As we can note from the contents of the First and Second Banking Directives, they did not contain any provisions on capital or prudential requirements. The Directives were, more or less, essential instruments for the achievement of the internal market from the point of view of banks having the freedom of establishment and the freedom to provide financial services to do business in other Member States. As we remember from the previous chapter, the BCBS adopted the Basel I in 1988 which meant that additional legislation was necessary if the EU wanted to introduce the concepts laid down in Basel I to the banks operating in the EU. During that time in the EU, Member States had various and different national rules in place regarding capital adequacy, and these systems were the end result of the distinctive features of national banking systems.[113] The EU adopted the principles laid down in Basel I with the introduction of two Directives: the Own Funds Directive[114] and the Solvency Directive[115]. Together with the Second Banking Directive, these three Directives laid down the foundation for banking regulation in the EU as the 80s were coming to an end with the beginning of a new decade.

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[110] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC (n 105) Article 18.
[111] ibid Article 4(1).
[112] ibid Article 9.
[113] Lucia Quaglia, 'The EU and Global Banking Regulation', *The European Union and Global Financial Regulation* (Oxford University Press 2014) 28.
[114] Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions 1989.
[115] Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions 1989.

The Own Funds Directive recognised the importance of banks' own funds in the creation of an internal market in the banking sector. Own funds play a key role in ensuring the continuity of banks and in the protection of savings, as also mentioned in its preamble. Given that banks had now the opportunity to establish themselves freely in other Member States and to offer financial services throughout the Union, it was necessary to legislate the banking market in a way that when banks engage in direct competition with each other, the definitions and standards pertaining to own funds should also be equal. If the task of determining the criteria for the composition of own funds were to have left to Member States, it would have nullified, to a certain extent, the other efforts made to harmonise the banking sector in the EU. It was in the best interests of the EU to adopt common basic standards to prevent distortions of competition and to strengthen the EU banking system. Therefore, the Directive laid down general principles on what the unconsolidated own funds of banks shall consist of, such as capital, reserves, and revaluation reserves.[116]

On the other hand, the Solvency Directive actually implemented the standards of Basel I. The Directive introduced a solvency ratio, which expressed own funds (defined in the Own Funds Directive) as a proportion of total assets and off-balance sheet items that were then risk-adjusted.[117] The total risk-adjusted values of assets and off-balance-sheet items acted as the denominator of the solvency ratio.[118] As in Basel I, the Solvency Directive introduced a total of four weighing categories (0, 20, 50, 100%) that were applied to the various categories of asset items.[119] Most importantly, the Directive imposed that banks were required to permanently maintain a solvency ratio of at least 8% (similar to Basel I).[120] In the case that the ratio fell below 8%, the competent authorities ensured that the bank in question took appropriate action to restore the ratio to the agreed minimum level as quickly as possible.

Alongside with the three Directives (namely the Second Banking Directive, Own Funds Directive and Solvency Directive), in 1993 the Capital Adequacy Directive was introduced to essentially extend the capital requirements from banks to investment firms.[121] Directive 93/22/EC on investment services in the securities' field allowed investment firms

[116] Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions (n 114) Article 2.

[117] Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions (n 115) Article 3(1).

[118] ibid Article 5.

[119] ibid Article 6.

[120] ibid Article 10.

[121] Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions 1993.

authorised by the competent authorities of their home Member States and supervised by the same authorities to establish branches and provide services freely within the EU, but it did not establish common standards for the own funds of investments firms nor did it establish the amount of the initial capital of such firms.[122] Therefore, investment firms were in a similar position to banks before the introduction of the First and Second Banking Directives. However, with the Capital Adequacy Directive the rules were harmonised to include provisions relating to initial capital and provisions against risks (incl. capital requirements).

2.2.2.1. CRD I

In 2000, the various banking Directives and their amending Directives became obsolete as they were replaced by one single Banking Directive.[123] Given that there were multiple different instruments that legislated the conduct of banks and investment firms, it was obvious that a revamp was necessary. The single Banking Directive was enacted for reasons of clarity and rationality to codify and combine the various Directives and their amendments into a single text.[124]

The objective of the Directive remained the same as with the ones that came before it: to eliminate the most obstructive differences between the laws of the Member States, and to achieve the internal market from the point of view of both freedom of establishment and freedom to provide financial services.[125]

The Directive was divided into different sections that, essentially, included the contents of the various Directives. These included requirements for access to the taking up and pursuit of the business of credit institutions, provisions concerning the freedom of establishment and the freedom to provide services, and principles and technical instruments for prudential supervision (incl. the solvency ratio). No changes were made to the solvency ratio and risk weightings as the publication of Basel II was still a couple of years away from publication, which then updated the solvency ratio and risk weightings. In that sense, the single Banking Directive did not bring anything new to the table in terms of capital requirements, but it focused on improving the clarity and transparency of the EU legislation.

[122] ibid Preamble.

[123] Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions 2000.

[124] ibid Preamble (1).

[125] ibid Preamble (2) and (4).

When the Basel II guidelines were adopted in 2004, the single Banking Directive was replaced by the Directive 2006/48/EC[126] that implemented the updated Basel II guidelines that the BCBS had worked on after realising the shortcomings of Basel I. In addition to the Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, another Directive was also enacted: Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions[127]. These two Directives can also be described as being the first Capital Requirements Directive (CRD).

Together, these two Directives transposed into EU law the Basel II rules on measures regarding own funds and capital requirements agreed by the BCBS. This prudential framework established by the two Directives established different approaches to capital adequacy for each risk (risk weights), which enabled banks and investment firms to put in place risk management systems that best suited their risk profile or area of activity. However, despite these legislative updates, the financial crisis between 2007-2009 showcased the inadequacy of the legislations and prompted the EU to adopt further pieces of legislation in the aftermath of the crisis.

2.2.2.2. CRD II

The EU responded to the financial crisis by enacting a second legislative package aimed at ensuring the financial soundness of banks and investment firms. The legislative package consisted of three new Directives that amended the Directives 2006/48/EC, 2006/49/EC and 2007/64/EC.[128] [129] [130] These new Directives were the first steps taken to address the shortcoming revealed by the financial crisis. In particular, the CRD II reviewed the definition of eligible capital under Article 57(a), and introduced new criteria under Article 63(a) for assessing whether certain hybrid capital instruments

[126] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (Text with EEA relevance) 2006.

[127] Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) 2006 49.

[128] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (Text with EEA relevance) 2009 111.

[129] Commission Directive 2009/27/EC of 7 April 2009 amending certain Annexes to Directive 2006/49/EC of the European Parliament and of the Council as regards technical provisions concerning risk management (Text with EEA relevance) 2009 27.

[130] Commission Directive 2009/83/EC of 27 July 2009 amending certain Annexes to Directive 2006/48/EC of the European Parliament and of the Council as regards technical provisions concerning risk management (Text with EEA relevance) 2009 83.

were eligible to be included in the own funds definition.[131] Especially regarding the hybrid capital instruments, the previous Directives were not aligned with international agreements, so the CRD II aligned the provisions of those Directives to the international agreements adopted by the BCBS.

2.2.2.3. CRD III

Not long after the enactment of CRD II, the EU adopted Directive 2010/76/EU that further amended the Directives 2006/48/EC and 2006/49/EC regarding capital requirements for the trading book and re-securitisations, as well as supervisory review of remuneration policies.[132] What prompted yet another round of amendments to the Directives 2006/48/EC and 2006/49/EC was an international agreement that the inappropriate remuneration structures of some financial institution were a contributory factor to the failure of individual financial institutions and systemic problems in the EU and globally.[133] The risks of remuneration policies which give incentives to take risks exceeding the general level of risk tolerated by banks had the potential to undermine sound and effective risk management and exacerbate excessive risk-taking behaviour.[134] Effectively, CRD III amended the earlier Directives by supplementing earlier requirements by an express obligation to establish and maintain remuneration policies and practices that are consistent with effective risk management.

2.3. Current legislative landscape in the EU

2.3.1. CRR I/II and CRD IV/V packages

After the CRD III legislative package, the legislative landscape was yet again scattered and confusing with multiple amending Directives to the original two Directives (2006/48(EC and 2006/49/EC). Furthermore, the BCBS had published Basel III guidelines in 2010 which prompted the EU to update its capital requirements and other important aspects regarding banks' activities. The result was the introduction of the Capital Requirements

[131] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (Text with EEA relevance) (n 128).

[132] Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies Text with EEA relevance 2010 76.

[133] ibid Preamble (1).

[134] ibid.

Regulation (CRR I) No 575/2013[135]. Alongside with the CRR, the Capital Requirements Directive 2013/36/EU[136] was also enacted to reflect the Basel III rules on capital measurement and capital standards. Together, these two pieces of legislation cover the capital requirements rules in the EU.

Shortly put, the Regulation can be described as having three main innovations compared to the previous instruments: 1) higher and better capital requirements, 2) liquidity measures, and 3) limiting leverage. Firstly, like the instruments that came before it, the Regulation requires banks to put aside enough capital to cover unexpected losses and, hence, keep themselves solvent in a crisis. The ultimate aim of the Regulation is to strengthen the prudential requirements of banks in the EU, following the Basel III rules on capital requirements. The amount of capital required depends, like before, on the risk attached to the various assets a bank holds. The riskier the assets are, the more capital a bank is required to put aside.

Not all capital is "created" equal, however. Under the Regulation, capital is graded according to its quality and risk. Tier 1 capital is considered to be "going concern" capital. What this means is that the going concern capital allows a bank to continue its activities and keeps it solvent in the event of a crisis. The highest quality of Tier 1 capital is called common equity tier 1 (CET1) capital. On the other hand, we have also Tier 2 which is considered to be "gone concern" capital. This means that gone concern capital enables a bank to repay its depositors and senior creditors in the event of insolvency. The total of amount of capital that banks are required to hold remains at least 8% of the risk-weighted assets.

Secondly, in regard to liquidity requirements, credits institutions must hold sufficient liquid assets to cover net liquidity outflows under gravely stressed conditions over a period of 30 days. A liquidity coverage ratio is used to monitor the capability of banks having suitable capital preservation to ride out any short-term liquidity disruptions.

Thirdly, the Regulation limits leverage between a bank's capital and its total assets. A bank's assets are leveraged when they exceed its own capital base. As we have seen earlier, excess leverage has a negative effect on banks' solvency, which is why under the Regulation banks are required to avoid excessive leverage and to disclose their leverage ratio.

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[135] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance 2013 (OJ L 176).

[136] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance 2013 36.

In addition to the CRR, two Directives have been passed that complement the CRR and continue the legacy of the previous Banking Directives. Firstly, we have Directive 2013/36/EU that concerns the activity of credit institutions and prudential supervision of such institutions and investment firms (Capital Requirements Directive CRD IV). As the name of the Directive suggests, the Directive lays down rules on prudential supervision, supervisory powers and tools, and the publication requirements that authorities must comply with. As we know, the Directive replaced the two former capital requirement Directives (2006/48/EC and 2006/49/EC) and it covers aspects previously included in those Directives (incl. access to the taking up and pursuit of the business of banks, conditions for freedom of establishment and the freedom to provide services).

Notably, the CRD IV provides more detailed requirements on the Pillar 2 framework[137], where Member State authorities may require banks to hold capital in addition to the minimum requirements laid down in the CRR. In addition, the CRD IV lays down a framework regarding capital buffers. The purpose of capital buffers is to protect a bank's solvency by setting safeguards and limits on the amount of dividends and bonus payments it can make.[138]

Quite a few years later, after the implementation of CRR I and CRD IV, CRR II and CRD V were enacted in 2019. The CRR II amended the CRR I on many fronts, including regards the leverage ratio, requirements for own funds and eligible liabilities, and large exposures.[139] On the other hand, the CRD V amended CRD IV as regard to exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.[140] Altogether, the amendments made to both the CRR I and CRD IV were due to the fact that even though they played an important part in reforming the

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[137] As a reminder, the Pillar 2 refers to the framework established in the Basel II accord. The Basel II framework operated under three pillars: capital adequacy requirements, supervisory review, and market discipline. Basel II is discussed in more detail in

[138] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance (n 136) Chapter 4.

[139] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (Text with EEA relevance.) 2019 (OJ L 150).

[140] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (Text with EEA relevance.) 2019.

financial system to more stable and resilient against many types of future shocks and crises, CRR I and CRD IV did not address all identified problems. This was partly due to the fact that the international standard setters (incl. the BCBS) had not finished their work on internationally agreed solutions and approaches to tackle those problems at the time.[141] These two amendments were the result of the completion of the international standards.

2.3.2. Division between the Regulation and Directives

As the current framework regarding capital requirements is divided into two legislative instruments, it is important to understand the difference between the two. The Regulation establishes strict and precise prudential requirements that all institutions need to comply with. On the other hand, the Directive governs the access to deposit-taking activities by maintaining the "single passport" model for taking up and pursuing banking activities within the EU. A simplifying table regarding the division of competencies can be found below.

Regulation	Directives
Capital	Access to taking up and pursuit of business
Liquidity	Exercise of freedom of establishment and free movement of financial services
Leverage	Prudential supervision
Counterparty credit risk	Capital buffers
Large exposures	Corporate governance
Disclosure requirements	Sanctions

Table 2: Division between the Capital Requirements Regulation and Directive

[141] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (Text with EEA relevance.) Preamble 2.

3. Relationship between Prudential Requirements and Competition Law

3.1. Competition in the Banking Sector

Banking, like any other area of business, is affected by competition and competition law in relation to many aspects. While banks are heavily regulated, as we have seen, that does not mean that they are not competing against one other. Competition plays an important part in the economy as it fosters efficiency through better allocation of resources, and hence improves the quality of goods and services.[142] Achieving higher efficiency in the banking sector is definitely desirable as it leads to decreased costs for the bank customers, meaning that more customers might be willing to change banks if one banks offers better rates and services than others. However, the banking sector is quite interconnected and requires some level of national and/or cross-border cooperation, e.g. collaboration between competitors, which may raise concerns from a competition law point of view. These collaborations are usually necessary for the proper functioning of the sector, as without collaboration banking would not work in the way it has been set up.

Competition in the banking sector is not an easy task to evaluate or to accurately describe. Factors such as switching costs and network effects in retail banking make it difficult to carry out a conclusive analysis.[143] Despite that, various academic papers have assessed the degree of competition in the EU banking sector using various indicators such as the Lerner Index and the Boone indicator. This paper does not go into the details regarding those indicators and how competition levels have been calculated and estimated, but focuses on the results of those calculations and what kind of meaning they have in relation to competition in the banking sector. In addition, switching costs and network effects are analysed in order to get a comprehensive understanding of the competition occurring in the banking sector.

3.1.1. Banking in the EU: A unique banking sector

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[142] Nicola Cetorelli, 'Competition among Banks: Good or Bad?' (2001) 25 Economic Perspectives 38.

[143] Elena Carletti and Xavier Vives, 'Regulation and Competition Policy in the Banking Sector', *Competition Policy in the EU* (Oxford University Press 2009) 263.

that fosters competition

The deregulation process and the creation of the Economic and Monetary Union have significantly aided the increase in the level of competition by creating a level playing field where banks are able to compete with one another across borders. The internal market abolished entry barriers between Member States, which opened up new possibilities for banks situated in the EU.[144] The pro-competitive deregulation process that took place in the EU boosted competition, as banks from Member States were free to branch out to other EU Member States. As these legislations specifically aimed to remove barriers to entry, the effect was that competitive conditions of financial markets were significantly improved.[145] However, while competition has increased as a consequence of the deregulation process, it is another matter whether the increased has had a positive impact on the banking sector.[146] Banking is a complex business area, meaning that further analysis is required to arrive at a coherent conclusion.

The banking sector in the EU has been subject to many structural adjustments affecting the way banks are able to conduct business. As these adjustments affect the core business activities of banks, these changes have naturally also had an impact on the level of competition in the form of e.g. increased concentration in the sector.[147]

We can begin the analysis by looking at one of the effects of the regulatory changes. Due to the deregulation process and the changes it has had on making cross-border activities easier for banks to conduct, there has been a trend towards consolidation.[148] Mergers and acquisitions (M&As) have increased in numbers meaning the market has concentrated as a result of increased cross-border capital flows, greater market contestability, and the ongoing process of privatisations of financial institutions.[149] From a competition law point of view, the effects of these structural developments are difficult to assess concretely, especially regarding their effect on the efficiency and stability of the banking sector. Generally speaking, high concentrations usually results in increased market power, which typically negatively affects both competition and efficiency. On the other hand, if the M&A transactions are driven by economies of scale, increased

[144] Bogdan Capraru and Nicoleta-Livia Pintilie, 'Assessing Competition in the European Union Banking Sector' (2017) 9 Review of Finance and Banking 7, 8.
[145] Nicola Cetorelli, 'Real Effects of Bank Competition' (2004) 36 Journal of Money, Credit and Banking 543, 544.
[146] Capraru and Pintilie (n 144) 8.
[147] ibid 7.
[148] ibid 8.
[149] ibid.

concentration has the potential to foster efficiency improvements.[150] On this note, changes in market conditions for banks are an area of particular interest in competition law. If the market conditions are changed significantly by e.g. increased concentration, there might be a cause for worry as increased concentration indicates, from an economic point of view, increased market power as well as increased influence in financial stability and soundness of the overall economy.[151]

Several academic papers have assessed the level of competition in the EU's banking sector using various indicators. The conclusion of these papers has been, to no surprise, that the most competitive banking sectors are in those Member States where the market is not dominated by few large banks.[152] In those Member States where the banking sector is the least competitive, there are several big banking entities that control that national market. From this point of view, concentration has had a negative impact on the overall competitiveness compared to Member States where the level of concentration is lower. This observation goes in line with the theory of perfect competition, where in a perfectly competitive market there are a large number of buyers and sellers.[153] If you remove market players from the market, the level of competition decreases in tandem with the missing market players. Here it should be noted that perfect competition is just a theory and in a real market setting perfect competition is impossible to achieve. Yet, the theory of perfect competition showcases the effect of having a large number of market players and how the number of market players affects the level of competition in a given market setting.

Coming back to the internal market, being part of the EU's internal market has a direct correlation with the increase on the level of competition.[154] The single market has enabled the facilitation of comparability in terms of costs within the EU. This has had multiple positive effects of helping consumers, enchanting intra-Union trade, and making business transactions overall less difficult to carry out.[155] The main advantages of the single market for the banking sector can be boiled down to the following aspects: 1) reduced prices for banking and financial services, 2) general growth of

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[150] ibid.

[151] ibid 7.

[152] ibid 18; Santiago Carbó and others, 'Cross-Country Comparisons of Competition and Pricing Power in European Banking' (2009) 28 Journal of International Money and Finance 115; Alin Marius Andrieş and Bogdan Căpraru, 'Competition and Efficiency in EU27 Banking Systems' (2012) 12 Baltic Journal of Economics 41.

[153] Alison Jones, Brenda Sufrin and Niamh Dunne, *Jones & Sufrin's EU Competition Law: Text, Cases, and Materials* (7th edn, Oxford University Press) 7.

[154] Capraru and Pintilie (n 144) 20; Alin Marius Andrieş and Bogdan Căpraru, 'The Nexus between Competition and Efficiency: The European Banking Industries Experience' (2014) 23 International Business Review 566, 566.

[155] Capraru and Pintilie (n 144) 20.

economic efficiency due to the reduced prices, 3) access to larger categories of markets, instruments, and services, and 4) greater efficiency of use of capital flows due to free movement.[156] What we can observe from these advantages is that banks in the EU are in a rather privileged position compared to banks in other countries, given the efficiencies deriving from the internal market.

Another noteworthy element regarding how the EU's banking sector consolidated increased competition instead of concentration is the removal of the currency barrier by the creation of the single currency, Euro. The introduction of the Euro reinforced the competition amongst European banks, forcing them to reconsider their strategic orientation.[157] Furthermore, the Euro led to increased internationalization and geographical diversification making practices related to banking more uniform (inline with the various legal acts introduced by the EU) and pricing more transparent.[158]

What we can observe from the evolution of the legislative landscape, the creation of the internal market, and the removal of the currency barrier is that the banking sector in the EU is in a rather good position when considering the competitiveness of the sector. Without the internal market and the legislation that supports the objectives of the internal market, banks would not have the same opportunities as they now have in the EU. As discussed earlier, the deregulation process opened up new possibilities for banks as they were able to branch out to other Member States freely with the banking licence they possessed from their home Member State. Furthermore, as banks were legislated more or less the same in all of the Member States, barriers to entry or expansion to other Member States were much lower.

In regard to prudential requirements, the same effect can be observed. With the implementation of the Basel guidelines, all banks in the Member States were subject to the same requirements, meaning that banks could not cherry-pick their home jurisdiction in order to avoid higher standards for prudential requirements. Without harmonization, this could have been the result.

3.1.2 Specific factors affecting competition in the banking sector

Moving to more specific factors, we turn our attention to specificities in the banking sector that affect the level of competition in the banking sector. The

[156] Andrieş and Căpraru (n 152) 42.
[157] Andrieş and Căpraru (n 154) 567.
[158] ibid.

focus will be on three factors that especially impact the business of banking: switching costs, asymmetric information and network effects.

Firstly, switching costs are an important source of market power in banking.[159] What this means is that if a consumer wishes to move from one bank to another, the customer is likely to incur various costs associated with the change of accounts, bill payments, or lack of information.[160] Therefore, the competitive effects of switching costs are two-fold: 1) switching costs lead to the exercise of market power once banks have established a customer base, and 2) switching costs incentivize fierce competition to expand the customer base.[161] What we can observe from these two competitive effects is that they complement and amplify each other. As switching costs incentivize competition to expand the customer base of a bank, banks may be inclined to offer very favourable deposit rates to new depositors. Once a bank has "locked in" these new depositors, it then has the motive to alter its deposit rates to be less favourable to the depositor, since the depositor is now less likely to change a bank because of the inevitable switching costs.

This effect is amplified if a bank in question has achieved significant market power through the aggressive expansion of its customer base. Through increased market power, a bank is able to dictate the terms it sets for its customers and, as a result, its competitors might not be able to compete with those terms. This might have either positive or negative consequences for customers. On the positive side, the terms set by a bank having significant market power might be more favourable compared to the bank's competitors. However, this brings us back to the problem of switching costs if the bank in question decides to later on make its terms less favourable to the customers. On the negative side, the bank in question might be in a position to have unrivalled market power, meaning that it could set terms as it sees fit, and customers do not really have any other options in terms of selecting another bank. What we can observe from all this is that switching costs are in fact an important source of market power for banks, as once a consumer becomes a depositor it is very unlikely that he/she will switch banks unless a customer deems the switching costs to be less than the various costs incurred due to unfavourable terms in his current bank.

Secondly, the asymmetric information problem presents a hurdle in the competitive landscape of banking. The asymmetric information problem has been already discussed in chapter 2.1, but as it also affects competition it

[159] Carletti and Vives (n 143) 264.
[160] X Vives, 'Competition in the Changing World of Banking' (2001) 17 Oxford Review of Economic Policy 535, 543.
[161] ibid.

ought to be looked at also in this context. As we remember, the asymmetric information problem is two-fold in the banking sector. On the one hand, when a bank lends money to a customer, it may not know the true risk it is taking on when it grants a loan. On the other hand, a bank guarantees its depositors a certain liquidity and return, but the true financial situation of the bank is hidden from the depositors.

In lending out money to customers, the bank always assumes a certain level of risk, as it can never be totally sure about the probability of the customer paying back the loan in full, with interest. This naturally affects the way banks engage in the lending process. Caution from the bank's side is always present, but also the state of the market has a wide impact on lending. If interest rates are low, meaning that money is cheaper to borrow, banks are typically inclined to lend out more money compared to when interest rates are higher. When banks lend out more money than under "normal" circumstances, naturally the asymmetric information problem is disregarded to some extent, given the possibilities of receiving new customers paying interests on their loans.

On the other side of the business of banking, the way depositors perceive the financial situation of a bank affects significantly the way banks are able to lend out money. If there is distrust or the depositors doubt the financial stability of a bank, the competitive possibilities of that bank are hindered, as it is not able to raise funds from the market as effectively. When a bank is unable to effectively raise funds from the market in the form of e.g. deposits, this has a direct impact on how active it can be on the lending side of the business.

Finally, network effects also have an impact on the competitiveness of the banking sector. Network effects can be described as introducing elements of non-price competition.[162] As an example, banks may offer advanced internet banking services in order to introduce vertical differentiation between banks and at the same time reduce the degree of horizontal differentiation. In other words, by introducing additional services that complement the foundation of banking as a business, banks are able to differentiate themselves vertically by offering services that normally might not be necessarily available to customers, and at the same time reduce the horizontal differentiation with other banks that have already introduced these types of services.

What we can observe from these factors is that competition in the banking sector is imperfect and there are many hindrances and barriers to entry which raise the costs associated with entering the sector or being active in it. Banking historically relies quite heavily on reputation and

[162] Carletti and Vives (n 143) 264.

branch networks, meaning that new entrants in the traditional world of banking are few and rare. This is especially true in retail banking. In corporate banking, relationships and asymmetric information are hindrances that typically force small and medium sized banks to stay local and not to branch out internationally. This however is changing with the push from internet banking. Neobanks (internet-only banks) have started to challenge the status quo by offering traditional banking services fully online and lowering the bar to switch over or to have multiple accounts in different banks. On the other hand, in other segments of banking (e.g. investment banking) competition occurs at an international level and is usually quite volatile.

3.2. Comparing the Objectives of Both Prudential Requirements and Competition Law

The objectives of legal acts are one of the most important, if not the most important, aspect about a legal act. The objectives lay down the foundational and fundamental principles through which the legislation impacts the everyday lives of people and businesses. Each and every single piece of legislation has an objective or objectives showcasing what that specific legislation is trying to achieve and the reasons why it is trying to achieve that. That is why these objectives are an integral part of analysing how two different pieces of legislation affect each other and on what level.

Given the rather unique nature of both prudential requirements and competition law, the objectives of both legislations are looked at and compared. This comparison is made to see whether there is a conflict in the objectives between the two, or whether are the objectives are some-what aligned, meaning that both pieces of legislation are ultimately trying to achieve the same goals. Once we know the foundational objectives of both prudential requirements and competition law, we can analyse the interplay between the two. As the objectives of prudential requirements and banking regulations have already been touched upon, a short section shall be first devoted to those objectives to remind ourselves what prudential requirements, and ultimately banking regulations, are trying to achieve. Then we move on to the objectives of competition law. Finally, a conclusion is made based on the assessment of the objectives considering whether they are in conflict with each other, or whether they somehow complement one another.

3.2.1. Prudential requirements

The objectives of prudential requirements can be boiled down to a simple mission: to improve the resilience of banks. Starting from the early days of universal prudential requirements, Basel I essentially laid down two fundamental objectives: 1) that the framework would serve to strengthen the soundness and stability of the international banking system, and 2) the framework would be in fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks.[163] The fundamental objective of strengthening the soundness and stability of the international banking sector has also been prevalent in the newer accords. Basel II's fundamental objective was to revise the Basel I accord to "develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks".[164] The concept of fairness here refers to how banks are regulated in a similar manner and, therefore, have the same requisites for competing against one another. Similarly, the objective(s) of Basel III was worded "to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy".[165] [166] Interestingly enough, the mentioning about competitive inequality was left out, probably due to the two previous Basel accords having already standardised the international banking system in a way that it was not such as prevalent issue when Basel III was published.

While these were the fundamental objectives of the Basel accords, those guidelines are not binding legal instruments. As mentioned earlier, the Basel accords laid down the underlying principles for prudential requirements that were then implemented into EU law by various legal instruments. For this reason, we need to also consider the objectives of the current legislative framework in the EU concerning prudential requirements: the CRR I/II and CRD IV/V.

[163] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards (Basel I)* (n 56) 1.
[164] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards - A Revised Framework (Basel II)* (n 63) § 4.
[165] Basel Committee on Banking Supervision and Bank for International Settlements (n 80) § 1.
[166] Basel Committee on Banking Supervision, *Basel III* (n 83) § 1.

The CRR I, as mentioned above, was adopted in order to create the "single rule book" that then replaced all the various legal instruments governing the banking activities (incl. prudential requirements) of European banks. As we remember, the rules between Member States differed quite a lot on some aspects which made the playing field of banking, as a business activity, uneven. The CRR I recognised this need to remove obstacles to trade and distortions of competition resulting from the divergences between Member State legislations, and to also prevent further likely obstacles and distortions of competition.[167] Therefore, for reasons of legal certainty and due to a need of establishing a level playing field, having a single set of rules for all market participants was a key element for the functioning of the internal market.[168]

In addition, as the CRR focused primarily on prudential requirements that related strictly to the functioning of banking and financial services markets, the rules set down by the CRR were meant to ensure the financial stability of the operators on those markets without forgetting the need to protect investors and depositors.[169]

Altogether, the CRR places a heavy emphasis on ensuring that regulatory arbitrage opportunities are removed in the EU by having a uniform and robust regulation that is directly applicable in the Member States. By having uniform rules that all institutions follow also boosts confidence in the stability of banks during times of stress.[170] Thus, it can be observed that by focusing primarily on having a uniform set of rules in the EU, prudential requirements are more effective and have a wider effect on the banking sector and the whole economy as a by-product.

While the CRR II brought some amendments to the CRR I, the objective of the Regulation remained more or less unchanged. Risk reduction measures were highlighted as a way to further strengthen the resilience of the banking system, and to also further progress the completion of the Banking Union.[171] The main objectives of CRR II were, however, to reinforce and refine the already existing EU legal acts, ensuring uniform

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[167] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance Preamble 11.
[168] ibid Preamble 9.
[169] ibid Preamble 7.
[170] ibid Preamble 12.
[171] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (Text with EEA relevance.) Preamble 4.

prudential requirements applying throughout the EU.[172] Therefore, the CRR II did not introduce any new objectives, but updated the existing EU rules on prudential requirements to accommodate for the internationally recognised standards.

Similarly to CRR I, CRD IV had the same objective of integrating the previous banking Directives into one Directive for the sake of greater accessibility and clarity. The main objective of CRD IV was to coordinate national provisions concerning access to the activity of banks and investments firms, the modalities for their governance, and their supervisory framework.[173] Importantly, as the CRD IV is to be read together with CRR I, the objectives of the two legal instruments are more or less the same.

The implementation of CRD V did not change this equation. Similarly to CRR II, the objectives of CRD V were to reinforce and refine the already existing EU legal acts, ensuring uniform prudential requirements that apply to banks throughout the EU.[174] Therefore, the CRD V and CRR II can be said to have identical objectives and no new objectives were per se introduced with the adoption of both CRD V and CRR II.

In conclusion, we can see two overarching goals that define the prudential requirements legislations in the EU: 1) to improve the resilience of banks, and 2) to create a uniform set of rules applicable in all Member States. The first goal derives from the original Basel accord's while the second is more specific to the EU's objectives to ensure the functioning of the internal market by removing obstacles to trade and distortions of competition. While it may seem at first sight that the goals of prudential requirements are in line with the objectives of competition law, we need to first dig a bit deeper to understand the approach competition law has taken in the EU.

3.2.2. Competition law

Analysing the objectives of competition law in the EU takes us first to the Treaty of Rome (EEC)[175]. In its fourth preamble, the following is stated: "the removal of existing obstacles calls for concerted action in order to guarantee steady expansion, balanced trade and fair competition."

[172] ibid Preamble 72.

[173] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance (n 136) Preamble 2.

[174] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (Text with EEA relevance.) (n 140) Preamble 29.

[175] Treaty establishing the European Community 1992 (OJ C 224).

Furthermore, in the objectives of the Treaty, the Treaty was aiming to achieve a number of wide-ranging and aspirational goals through economic integration (the common market).[176] The common market was not an end itself, but rather a mean of pursuing the goals and objectives listed in Article 2 of the Treaty.[177] Article 3 of the Treaty of Rome laid down a rather broad range of activities that were necessary for the purposes set out in Article 2. This included "a system of ensuring that competition in the internal market is not distorted".[178] Article 3(1)(g) played a rather important role, as it embedded the principle of undistorted competition in the fundamental provisions of the Treaty of Rome.[179] In the *Continental Can*[180] case, the Court of Justice (CJ) considered Article 3 being the foundation of specific competition rules in the Treaty and referred to it in interpreting those rules.[181]

Following the Treaty of Rome, the Treaty of Lisbon transformed the EC into the EU and amended the TEU and EC Treaties (now named the Treaty on the Functioning of the European Union, TFEU[182]).[183] As laid down in the TEU and TFEU, the EU shall establish an internal market that comprises an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured.[184] [185] As we can derive from the wording of both TEU and TFEU, neither of them replicate Article 3(1)(g). Although Article 3(3) of the TEU concerns the establishment of the internal market, it does not contain anything regarding competition. Hence, there is no Treaty provision referring to undistorted competition, unlike in the Treaty of Rome.[186] However, that does not mean that the principle of undistorted competition is left out in its entirety from the Treaties. In Protocol No. 27 on the Internal Market and Competition that is annexed to and forming an integral part of the Treaties alongside with other Protocols, it is stated that "the internal market as set out in Article 3 of the Treaty on European Union includes a system ensuring that competition is not

[176] ibid Article 2.
[177] Jones, Sufrin and Dunne (n 153) 40.
[178] Treaty establishing the European Community Article 3(1)(g).
[179] Jones, Sufrin and Dunne (n 153) 40.
[180] *Europemballage Corporation and Continental Can Company Inc v Commission of the European Communities* [1973] ECJ Case 6-72.
[181] ibid Chapters 6-7.
[182] Consolidated version of the Treaty on the Functioning of the European Union 2012 (OJ C 326).
[183] Jones, Sufrin and Dunne (n 153) 41.
[184] Consolidated version of the Treaty on European Union 2012 (OJ C 326) Article 3(3).
[185] Consolidated version of the Treaty on the Functioning of the European Union Article 26.
[186] Jones, Sufrin and Dunne (n 153) 41.

distorted".[187] Importantly, we need to also remember that competition is one of the exclusive competences of the EU, as it is listed under Article 3 of the TFEU.

Given the wording of both Protocol No. 27 and Article 3(1)(g) of the Treaty of Rome that came before it, it is clear that the function of EU competition law is to prevent distortions in the internal market, and, by ensuring that competition in the internal market is not distorted, to achieve the objectives of the EU. On this note, the CJ stated in *Continental Can* in 1974 that the competition provisions (Article 101 and 102 TFEU) both seek to achieve the aim of the maintenance of effective competition.[188] Furthermore, the EU Merger Regulation (EUMR) uses a test of (significant) impediment to "effective competition" when judging the compatibility of mergers within the single market.[189]

What has been discussed above refers to the general objectives of EU competition law. What about the substantive provisions themselves? Do Articles 101, 102 and 106 TFEU offer us any more specific insight to any particular policies that those provisions aim to achieve? The answer to these questions is yes and no. While these provisions do not express any particular policy, they do contain concepts that are significant in showcasing the objectives of those provisions. If we look at Article 101, we can observe that there are references to fairness and to consumers in the exemption provision in Article 101(3) TFEU. On the other hand, Article 102(a) TFEU contains the prohibition of the imposition of unfair prices and trading conditions from dominant firms, and a prohibition on limiting production, markets, or technical development to the detriment of consumers in Article 102(b) TFEU. Therefore, the status of consumers is relevant both in Article 101 and 102 as both articles serve the same purpose, just on a different level as confirmed also in *Continental Can*.[190] Thus, while the substantive provisions do not expressly state any particular policies that they aim to achieve, the promotion of fair competition is still an integral part of the overarching general objective of EU competition law as can be seen from what wording of Article 101.

Finally, as we can see from the wording of the Treaty of Rome, competition policy plays an integral part towards the achieving the objective of European economic integration. The internal market would not have been

[187] Consolidated version of the Treaty on European Union - PROTOCOLS - Protocol (No 27) on the internal market and competition 2008.
[188] *Europemballage Corporation and Continental Can Company Inc v Commission of the European Communities* (n 180) para 25.
[189] Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) 2004 Article 2(3).
[190] *Europemballage Corporation and Continental Can Company Inc v Commission of the European Communities* (n 180) para 25.

possible without the introduction of EU-wide competition rules that prevent anti-competitive national measures from negatively affecting competition. The EU Courts as well as the Commission have repeatedly stressed the importance of competition law in achieving the internal market to what it is now. For example, in *GlaxoSmithKline* the CJ stated that agreements limiting parallel imports have the object of restricting competition contrary to Article 101 TFEU by referring to the Treaty's objective of achieving the integration of national markets through the creation of a single market.[191] On the other hand, in the Guidance on Article 102 enforcement priorities, the Commission states that it may intervene in relation to certain behaviour that undermines the achievement of an integrated internal market.[192] Therefore, it is rather clear that one of competition law's fundamental objectives is to also ensure the proper functioning of the internal market and the overall economic integration of the EU.

Now that we have a clear understanding of the objectives in relation to prudential requirements and competition law, we can see that both types of legislations are trying to achieve, more or less, complimentary objective(s). Especially in relation to the EU legislation, the functioning of the internal market is of paramount importance. The EU prudential requirements focus on the functioning of the internal market, as well as having a uniform set of rules complimenting that objective. These objectives go hand in hand with the goals of competition law is set out to achieve. Interestingly enough, the BCBS also highlighted the importance of competition in the Basel accords by emphasizing the importance of diminishing an existing source of competitive inequality among international banks. Therefore, it can be concluded that the objectives of prudential requirements and competition law are not in conflict with one another, but actually, on some level, compliment one another depending on the context of application. The differences in objectives can be explained by the difference in the subject matter of the legislation that relates to the specific context, but the overarching objectives are more or less complimentary.

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[191] *GlaxoSmithKline Services Unlimited v Commission of the European Communities (C-501/06 P) and Commission of the European Communities v GlaxoSmithKline Services Unlimited (C-513/06 P) and European Association of Euro Pharmaceutical Companies (EAEPC) v Commission of the European Communities (C-515/06 P) and Asociación de exportadores españoles de productos farmacéuticos (Aseprofar) v Commission of the European Communities (C-519/06 P)* [2009] ECJ Joined cases C-501/06 P, C-513/06 P, C-515/06 P C-519/06 P paras 59-62.

[192] Communication from the Commission — Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (Text with EEA relevance) 2009 para 7.

4. Assessing Stability and Competition

Competition in the banking sector is likely to have a significant positive impact on growth.[193] This is suggested by both economic theory and empirical evidence.[194] Given the importance of competition and its impact on growth, this sets a kind of "requirement" for prudential requirements not to hinder competition. On the other hand, recent events in the world of finance and the overall economy have been a dark reminder of the importance that prudential requirements play to ensure stability. The culmination of the interplay between prudential requirements and competition law ultimately boils down to the balancing of two interests that have complimentary objectives, but might clash when those objectives are pursued: stability and competition.

This chapter goes into detail about the interplay between stability deriving from prudential requirements and competition that is fostered by competition law. The past chapters have aided us in understanding e.g. the background of banking as a business, prudential requirements and how competition is present in the banking sector. These are all important factors to take into consideration before dealing with the intricacies of the interplay between the two opposing sides of a coin. As we know, competition law fosters healthy competition in the markets that increases growth and consumer welfare. Prudential requirements, on the other hand, are implemented to safeguard the overall economy from greed and excessive leverage by imposing strict capital requirements on banks. Therefore, prudential requirements set a certain burden on competition, that forces banks to act in a certain way which they might not be otherwise inclined to do.

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[193] Rudiger Ahrend, Jens Matthias Arnold and Fabrice Murtin, 'Prudential Regulation and Competition in Financial Markets' 5 <http://www.oecd.ilibrary.org/economics/prudential-regulation-and-competition-in-financial-markets_220117664431> accessed 31 January 2022.

[194] See for example Jith Jayaratne and Philip E Strahan, 'The Finance-Growth Nexus: Evidence from Bank Branch Deregulation' (1996) 111 The Quarterly Journal of Economics 639; Kevin J Stiroh and Philip E Strahan, 'Competitive Dynamics of Deregulation: Evidence from U.S. Banking' (2003) 35 Journal of Money, Credit and Banking 801; Alain de Serres and others, 'Regulation of Financial Systems and Economic Growth' (OECD 2006) <https://www.oecd-ilibrary.org/economics/regulation-of-financial-systems-and-economic-growth_870803826715> accessed 14 May 2022.

4.1. Impact and Importance of the Recent Financial Crisis

The financial crisis had a massive impact on the world and EU economy, and it took around five years, respectively, for the European stock market to reach its pre-crisis peak. The magnitude of its impact left long-lasting scars, and we can still see its effects to this day. As we saw in Chapter 2, the crisis sparked a frenzy to update the legislations that were supposed to protect the economy from a meltdown. While the global financial crisis was horrific in almost every way, it shaped the way prudential requirements and competition law interact with each other in the EU.

The EU was in full crisis mode when the shockwaves moved from the US on to the European soil following the bankruptcy of a bank called Northern Rock in the UK.[195] During this period, the then-EU Competition Commissioner Neelie Kroes emphasized the importance of competition policy as a vital element of the solution to the crisis.[196] Commissioner Kroes gave a warning that "giving up on competition was the surest way to waste state aid funds and hurt consumers as they began to hurt from job losses, home foreclosures, and the general economic malaise".[197] This set the tone of how the European Commission, and the whole EU for that matter, approached the financial crisis.

Before moving any further, it should be noted that it is the responsibility of the Commission, as the Union competition authority, to take action against policies adopted by Member States that would favour and give an advantage to local entities, such as banks. Article 107 TFEU effectively states that any aid granted by a Member State or through State resources which distorts or threatens to distort competition shall be incompatible with the internal market. Article 107(2) TFEU exempts certain categories of aid from this general prohibition and Article 107(3) TFEU provides a possible justification for state aid, e.g. to remedy a serious disturbance in the economy of a Member State. Therefore, policies that have the potential to affect the functioning of the internal market typically require the approval from the Commission.

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[195] 'The Collapse of Northern Rock: Ten Years On' *BBC News* (11 September 2017) <https://www.bbc.com/news/business-41229513> accessed 16 May 2022.

[196] Albert A Foer and Don Allen Resnikoff, 'Competition Policy and "Too Big" Banks in the European Union and the United States' (2014) 59 Antitrust Bulletin 9, 12.

[197] Neelie Kroes, 'Competition Policy and the Crisis – the Commission's Approach to Banking and beyond.' (European Commission 2010) Competition Policy Newsletter 2010 NUMBER 1.

Commissioner Kroes made an important statement where she showcased the advantages gained by the beneficiaries of state aid in the context of rescue operations by Member States. She noted that state aid had the possibility to aid the recipient banks to obtain market power, which, in turn, could have led to a situation where these recipient banks could have raised prices and restricted output.[198] This would have created a situation where additional harm could have been caused to the consumers and further deepened the recession.[199] Therefore, coherent competition-based restrictions on state aid were necessary to ensure that no additional harm were to fall upon the consumers.

While the Commission took an active role in ensuring that the approach taken to tackle the crisis had competition elements in mind, the EU Member States were given a certain degree of flexibility to apply state aid rules urgently as a response to the crisis.[200] However, despite the urgency deriving from the financial crisis there still had to be adequate legal certainty and the prevention of distortions in the internal market was kept as a priority by ensuring consistency in the assessment of competition issues.[201] It was recognised that Member States could have been prone to saving themselves instead of mutually focusing on reviving the whole EU economy. As an illustration of the focus on legal certainty and consistency, remedial measures had to be non-discriminatory so that recapitalisation plans were available to all banks with systematic relevance to the economy.[202] This was done to ensure that Member States did not favour their national champions, but recapitalisation plans were applied without regard to origin.

Overall, the primary concern of the Commission was to ensure that any national rescue measures were compatible with EU competition law.[203] Therefore, the Commission was on a mission to take necessary action in ensuring that the rescue measures, namely state aid, would be used in a way that maintained a level playing field between Member States instead of having a spillover effect that could have resulted in the problems being

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[198] Foer and Resnikoff (n 196) 13.
[199] ibid 14.
[200] Lella Cejnar, 'After the Global Financial Crisis: Key Competition Law Developments in Australia, the United States, the EU and the UK' (2011) 5 Law & Financial Markets Review 201, 207.
[201] ibid.
[202] Damien MB Gerard, 'EC Competition Law Enforcement at Grips with the Financial Crisis: Flexibility on the Means, Consistency in the Principles' (Social Science Research Network 2009) SSRN Scholarly Paper 1338000 52 <https://papers.ssrn.com/abstract=1338000> accessed 16 May 2022.
[203] Damien MB Gerard, 'Managing the Financial Crisis in Europe: Why Competition Law Is Part of the Solution, Not of the Problem' (Social Science Research Network 2008) SSRN Scholarly Paper 1330326 2 <https://papers.ssrn.com/abstract=1330326> accessed 16 May 2022.

transferred from one Member State to other Member States.[204] Ultimately, the concern was to prevent unfair competition among banks and to avoid a subsidy race between Member States by promoting compliance with the general single market principles.[205]

One important aspect about the approach taken by the Commission was that the Commission set certain conditions for support given by the Member States. In order to prevent inefficient banks from crowding the market to the detriment of healthy competitors, the European Commission required those banks to undergo restructuring (incl. reduction in size or divestment).[206] Restructuring was viewed as an absolute condition, meaning that if an inefficient bank did not go through with the restructuring process, no aid could be given to that bank.

However, despite all the efforts taken by the Commission and the EU as a whole, the problem that the Commission and EU Member States were faced with was that there were a wide range of urgent national approaches to the crisis, which made coordination throughout the EU difficult.[207] Fortunately, a coordinated response was made by the "Eurogroup" (Member States having the Euro as their currency).[208] The response came in the form of common principles aimed at responding effectively to the crisis, but at the same time ensuring compatibility with EU single market principles.[209] This common response assisted the coordination and ensured that steps taken had a more widespread and effective impact.

Overall, the approach taken by the EU and the Commission was to take both legislative action regarding capital requirements without forgetting the proper application of competition law. This combination ensured that issues relating to competitiveness and competition overall were not disregarded when the discussion revolved around surviving the financial crisis and preventing a prolonged recession. There have been strong indications that this approach proved to protect competition during the financial crisis, avoid unnecessary market consolidation, and preserve regulatory goals of good bank performance.[210]

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[204] European Commission, 'State Aid: Commissioner Kroes Briefs Economic and Finance Ministers on Financial Crisis Measures' (2008) Commission press-release MEMO/08/757.
[205] Gerard (n 203) 11.
[206] Jonathan M DeVito, 'The Role of Competition Policy and Competition Enforcers in the EU Response to the Financial Crisis: Applying the State Aid Rules of the TFEU to Bank Bailouts in Order to Limit Distortions of Competition in the Financial Sector' (Social Science Research Network 2011) SSRN Scholarly Paper 1809772 15 <https://papers.ssrn.com/abstract=1809772> accessed 16 May 2022.
[207] Cejnar (n 200) 207.
[208] Gerard (n 202) 46.
[209] ibid.
[210] Foer and Resnikoff (n 196) 16.

Interestingly, if we turn our attention to the US and how it handled the crisis, their approach differs quite a lot from the EU's and Commission's. While the EU responded to the crisis with competition being part of the solution, the US took another approach. The US Treasury officials orchestrated the sale of Bear Stearns to JPMorgan Chase, and additionally may have been actively imposing the sale of Merrill Lynch to Bank of America.[211] Therefore, the response from the US to the financial crisis was consolidation. These acquisitions substantially increased the consolidation in the financial services industry within the US and changed the balance of assets held by these banks.[212] After the crisis in 2012, it was observed that the "Big Six" to which JPMorgan Chase and Bank of America belonged to had combined assets totalling 60% of gross domestic product.[213]

What we can observe from this difference in approach is that the EU's strong focus on the application of competition law and state aid rules seemed to have avoided making banks bigger as a sort of side effect by making weak banks financially stronger. On the other hand, bank consolidation in the US was actually encouraged by the US government, and this resulted in acquisitions resulting in massive conglomerates that hold assets worth more than half of the US gross domestic product.

4.2. A Tug of War

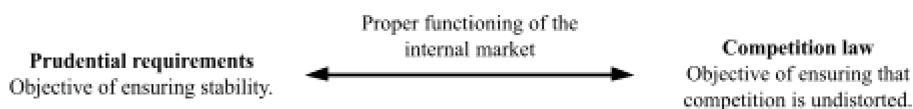
As we can observe from the financial crisis, prudential requirements and competition law intertwine with one another. This indicates that coordination between the two areas of law is vital in surviving future financial crises. However, the financial crisis required a certain degree of give-and-take that ultimately affected competition law, indicating that the two areas of law do not live in total harmony with one another.

The financial crisis showcased that the interplay between prudential requirements and competition law could be described as a state of a "tug of war". A tug of war refers to "a struggle for supremacy or control, usually involving two antagonists".[214] Let us use this analogy to help us understand whether there is a state of restlessness between the two areas of law, or whether the complimentary nature is the prevalent state between the two areas of law.

On the one side we have prudential requirements that "pulls" the market towards stability and strict rules imposed on banks, while

[211] ibid 17.
[212] ibid 18.
[213] ibid.
[214] 'Definition of "Tug-of-War"' <https://www.merriam-webster.com/dictionary/tug-of-war> accessed 16 May 2022.

competition law pulls into the opposing direction, towards undistorted competition in the internal market. Yet, they meet in the middle as the objectives of both prudential requirements and competition law are on a certain level to ensure the functioning of the internal market as showcased in Chapter 3.2 (Graph 2).



Graph 2

Next, we will be looking at this analogy in more detail to, hopefully, arrive at a coherent conclusion on the interplay between prudential requirements and competition law, and whether there actually is a "tug of war" between the two areas of law.

As we know from the content of the previous chapters, competition law focuses on ensuring that there is a level playing field in the market where competitors may freely compete against each other and that competition is undistorted. Prudential requirements, on the other hand, are meant to stabilize the economy and to protect the banking system from e.g. excessive leverage and risk-taking. Leverage and risk-taking are both elements that derive from banks being overly competitive against one another so that they resort to actions that have the potential to harm customers, depositors and creditors. This problem was illustrated in the introduction by concretely showing the impact of excessive leverage on ROE for investors.

In the example, the more leveraged the bank was, the ROE increased in proportion to the leverage. Therefore, a quick conclusion can be drawn that without any prudential requirements, competition law has a destabilizing effect on the economy as it promotes undistorted competition within the internal market. In other words, as competition law promotes undistorted competition where market players are able to compete freely against one another, banks would be motivated to leverage themselves to increase their profits and possibly also market share. As we know, excessive leverage has a destabilizing effect on the market, given the fragility of overleveraged banks. This analysis is supported by the fact that ever since the deregulation process of banking regulation has started, financial crisis

have become more frequent due to the increase in competitiveness in the banking sector.[215]

This would not be necessarily true if it were not for the special nature of banking and limited liability companies. Banks differ from other businesses as they are typically more regulated than other sectors of the economy. As banks are heavily integrated and involved in every other business activity, it is vital that banks are continuously able to operate soundly and efficiently. In other words, banks should act in a way that does not pose a threat to the overall economy. However, the inherent incentive of limited liability companies to maximize profits continuously corrupts the financial integrity of banks, as there is a significant financial reward for over leveraging.

As we will see, this argument that competition and competition law has a destabilizing effect on the economy from a financial perspective is actually rather flawed. By stating that competition destabilizes the economy, this argument disregards one importance factor about EU competition law: consumer welfare.

During the 1990s, the Commission took a step towards realigning competition law with economic thinking on efficiency and welfare.[216] In addition, the Commission adopted the so-called "effects-based approach" when applying the consumer welfare approach.[217] Consumer welfare refers to a standard where it is concerned with the transfer of surplus from producers to consumers.[218] In other words, consumer welfare focuses on the fact whether consumers are better or worse-off as a result of certain economic activity. If an activity and/or measure benefits consumers, it can be seen as being compatible with competition law. If not, it cannot be argued that that type of activity/measure should be seen as acceptable under competition law.

When the Commission adopted this consumer welfare standard, it simultaneously rejected broader objectives (e.g. economic freedom and the protection of competitors), but also the total welfare approach.[219] What this essentially means is that the Commission is concerned with distributive effects in relation to consumers, as showcased by the wording of Article 101(3) TFEU where a "fair share" of the efficiency gains resulting from anti-competitive behaviour must be passed on to consumers.[220]

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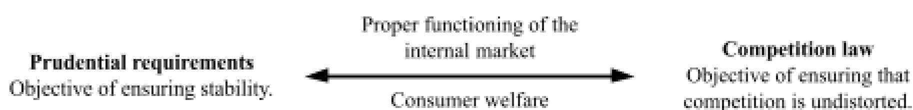
[215] Thomas F Hellmann, Kevin C Murdock and Joseph E Stiglitz, 'Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?' (2000) 90 American Economic Review 147, 148.
[216] Jones, Sufrin and Dunne (n 153) 46.
[217] ibid.
[218] ibid 12.
[219] ibid 46.
[220] ibid.

Because of the consumer welfare standard, the argument made previously that competition law has a destabilizing effect on the economy loses its momentum, as that would then indicate that the consumer welfare approach is not applied in the application of EU competition law. Since competition law takes into account the distributive effects in relation to consumers, destabilizing the economy would go contrary to that objective. Therefore, competition law cannot have a destabilizing effect, as that directly contradicts the consumer welfare standard. Hence, the graph should be updated to look something like this.



Graph 3

Graph 3 adds the element of consumer welfare to the equation, in the middle between both competition law and prudential requirements. The reason why it has been situated in the middle is due to the fact that while EU competition law nowadays uses the consumer welfare approach, prudential requirements is also ultimately concerned with consumer welfare through stability. If the whole economy is extremely volatile and vulnerable due to a rogue banking sector, consumer welfare would definitely suffer in the long run. As banking is such a vital sector for the whole economy, competition law has to make certain concessions on competitiveness and the level of competition for the benefit of financial security and predictability provided by stability.

The functioning of the internal market is in a similar position with consumer welfare. As the graph shows, the functioning of the internal market is also situated between prudential requirements and competition law. Neither of the two areas of law are able to achieve that objective if no concessions are made that benefits the other side. The internal market would not work properly if competition law could steam roll all efforts made to regulate banks' prudential requirements. On the other hand, if no regard is given to competition law during a crisis and prudential requirements offer a safe harbour to do almost anything, this dynamic could not result in a functioning internal market. This latter scenario was proven to be the case in the US when it chose the path of consolidation instead of a competition-based approach, and the result was the birth of massive conglomerates, decreasing the overall competitiveness of the sector in the US.

Now, this chapter started off by stating that there is a tug-of-war occurring between prudential requirements and competition law. While this is true in a sense that prudential requirements and competition law pull themselves in different directions as a way of achieving individual and common objectives, this dynamic between the two areas of law is not set in stone. As proven by the financial crisis, this dynamic is flexible in a way that enables the EU and the Commission to maximize the potential value of both prudential requirements and competition law by, yes, making concessions, but ultimately ending with a result that is a combination of the best of both worlds.

This ultimately shows the flexibility and vision of the EU to exercise strict prudential supervision with still a very focused emphasis on competition and the effective application of competition law. Even if it could have been seen as an easy way out to create massive conglomerates through cross-border mergers and acquisitions during the crisis, the internal market retained a degree of competitiveness. Here it should be noted that the banking sector in the EU is more concentrated now compared to before the financial crisis, but this was not due to deliberate action taken by the EU. Instead, the increased concentration was a result from, more or less, normal market behaviour.

Conclusion

As we have witnessed, banking truly is a special area of business that also requires special kind of legislation. The inherent structural problem of banks and the form of limited liability company creates a unique situation where banks have the potential to harm the whole economy if their risk taking and capital requirements are not (strictly) regulated.

The global deregulation process of the banking sector also swept across the EU and changed the landscape of how banks were able to conduct business. While banks had more freedom than ever before, the deregulation process had harrowing effects in the form of financial crises that shook the global economy. Global concerns in the banking sector were responded in the form of the Basel guidelines drafted by the BCBS. The EU also ratified these guidelines into directives and then regulations to harmonise the way banks are being legislated throughout the internal market.

This harmonisation process can be described as a success, since banks had suddenly the opportunity to expand to other Member States with their home state licence. The freedom of establishment and to provide financial services opened up new opportunities and increased the level of competitiveness prevalent in the banking sector. While banking is subject to various factors affecting the level of competition (e.g. asymmetric information and network effects), the internal market has created a unique banking sector where the effect of those factors are less harmful. The transparency created by uniform rules have catered for a banking sector where competition is healthy and thriving.

Looking at the objectives of both prudential requirements and competition law showed that both areas of law have, on some level, complimentary objectives. While the individual objectives naturally differed, the overall objective of ensuring the functioning of the internal market was the same. The way prudential requirements and competition law approached this overarching objective of ensuring the proper functioning of the internal market differed, as prudential requirements is concerned with increasing the resilience of banks that, as a by product, accounts for ensuring the proper functioning of the internal market. On the other hand, competition law focuses on ensuring that competition remains undistorted. If competition remains undistorted, the internal market is also able to function properly, given that there are no artificial hindrances to competition present in the market. The objectives of both areas of law can be described as working towards the same goal, just with different approaches.

Finally, an assessment was made to see whether the objectives themselves (stability and competition) were in a state of tug of war with one

another. The recent financial crisis helped us to understand the flexibility in the application of both prudential requirements and competition law. The approach taken by the Commission and the EU during the financial crisis had a heavy emphasis on competition being part of the solution to the crisis. This ultimately worked as the EU succeeded in preventing unnecessary consolidation unlike in the US where the response, more or less, relied on massive mergers and acquisitions.

The tug of war argument between prudential requirements and competition law cannot be stated to hold water, as the dynamic between the two areas of law is not set it stone. Not only are the overarching objectives of both prudential requirements and competition law to ensure the functioning of the internal market and to ensure consumer welfare, the two areas of law are flexible to adjust to the context at hand. While, yes, prudential requirements and competition law might clash swords at certain points, that does not mean that the relationship between the two areas of law would be somehow hostile. Both prudential requirements and competition law are able to effectively accommodate one another for the achievement of common objectives, as it was showcased to be the case during the financial crisis. If competition law had not been regarded as part of the solution to the crisis alongside with prudential requirements, the approach taken by the EU could have had anti-competitive elements and had detrimental effects in the long term for consumers and the economy.

Therefore, instead of claiming that prudential requirements and competition law are in a state of tug of war, the two areas of law can be described to accommodate one another and to be flexible in its application when needed. This relationship is better described as a symbiosis, where the scale might tip one way or the other, but it is always in balance.

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