

REGULATION AND COMPETITION IN EUROPEAN
FINANCIAL MARKETS : THE CASE OF BANKING
IN BELGIUM

par Franklin EDWARDS

Document de travail CRIDE 702

REPRINT

The author is Associate Professor of Economics, Columbia University School of Business. This paper was done while the Author was a Visiting Professor at the Institut des Sciences Economiques, Université Catholique de Louvain, where he was attached to the Centre de Recherches Interdisciplinaires Droit-Economie.

REGULATION AND COMPETITION IN EUROPEAN FINANCIAL MARKETS:
THE CASE OF BANKING IN BELGIUM *

To speak of applying a competitive policy to financial markets may strike many in Europe as a strange and futile exercise in economic theory. For years financial markets have been synonymous with large-scale government intervention and extensive regulations. Competitive policy was thought to have little or no applicability to these markets because of their regulated character.

Much the same attitude prevailed in the United States until the mid - 1950', when, rather suddenly, competition in banking emerged as a relevant public policy consideration. Manifestations of this policy shift are the Bank Holding Company Acts of 1956 and 1966 and the Bank Merger Acts of 1960 and 1966. In 1963 an entirely new dimension was added - the Supreme Court declared that antitrust laws were also fully applicable to commercial banking (1). No longer were banks (and perhaps other financial institutions) absolved from responsibility under the antitrust laws, as indeed they had believed for more than sixty years. By 1967 this competitive

* As this paper is an outgrowth of a conference which the author gave for the Société Royale d'Economie Politique de Belgique, he wishes to thank Baron van der Rest and the other members of the Société for their kind invitation. The author has benefited extensively from numerous enlightening discussions with his colleagues Alex Jacquemin and Robert Witterwulgho. He also appreciates the patience of his students at Louvain on whom many of his ideas were first tested.
(1) U.S. v. Philadelphia National Bank, 374 U.S. 321(1963).

trend was formally extended to nonbank savings institutions under the Savings and Loan Holding Company Act, and government antitrust sleuths are presently threatening legal action against brokerage firms, insurance companies, mutual funds, and any other financial institution which engages in anticompetitive practices (1).

In Europe, as in the United States, financial markets have exhibited rapid growth in the postwar period. Nevertheless, European financial markets have failed to attain the same breadth and depth and have from time to time shown remarkable unresponsiveness. Innovations of new financial services have been slow in coming and, when finally developed, have been marketed in an unaggressive, lackadaisical way.

In this paper, I shall argue on the one hand that the lack of vigorous competition in European financial markets has been an important reason for their retardation. In particular, the banking industry in Belgium demonstrates that European financial markets are typically not competitive enough to assure efficient social performance. (Banking is singled out for study because it is an important financial industry and because, at least in the case of Belgium, it is ostensibly as competitive as are most European financial markets)(2). On the other hand, it will be contended that the application of a competitive policy to European financial

(1) From 1960 to 1969, the Department of Justice challenged thirty-one bank mergers under the antitrust laws.

(2) In an important sense, banks are also unique financial institutions. They are the only private institutions permitted to supply both demand deposits and short-term business loans. As such, all of their products may intrinsically carry an aspect of "product differentiation".

markets would do much to improve their performance. Specifically, present public regulation should be changed to encourage more freedom of decision-making for individual participants and to permit market forces to reward efficiency and to penalize inefficiency.

The following discussion begins with a brief summary of the merits of having competition in financial markets. Next, I consider the issue of whether public regulation in any form is desirable. From this general discussion I turn to the more specific. First, evidence is presented to show that banking is presently not highly competitive; and, second, I argue that the absence of competition in banking is due to excessively restrictive public regulation as well as to certain private restraints on competition. Finally, several policy changes are recommended, changes which the author believes would improve the market performance of banks and other financial institutions.

The Need for Competition in Financial Markets

Generally, competition is desirable because of its effects on market performance and on the allocation of scarce resources. Financial markets are not an exception to this general rule, and in some ways efficient social performance is even more needed in financial markets. As the nerve-centers for our complex exchange economies, financial markets do much to either enhance or thwart economic welfare. For example, a low transaction cost encourages economic specialization and efficiency, while a variety of attractive savings options stimulates saving and fosters economic growth.

Although impossible to calculate with precision, the social cost of sub-optimal performance in these markets is surely very great.

More specifically, competition is desirable because of its beneficial effects on allocative efficiency, productive efficiency, and product innovation (1). In the absence of competitive markets, the problem of allocating resources becomes formidable. Prices, or in this case interest rates, can no longer be used to guide resources to their most productive ends. Too much of one product is produced and not enough of another.

Since the chief resource allocated by financial markets is credit, the consequences of misallocation are far-reaching. If financial institutions acquire monopoly power over some industries but not over others, the flow of credit will be distorted in favor of the latter, causing a distortion in productive output. More important, however, is that such credit discrimination also gives some enterprises an unfair advantage over their competitive rivals, and may eventually enable favored firms to acquire monopoly power in their own markets (2). Discriminatory credit terms may also be a serious barrier to potential entrants. The critical role which credit plays as a productive input, therefore,

(1) Although an "equitable" income distribution is omitted from these goals, it is implied by them.

(2) Empirical studies have shown that less competitive banking markets result in higher loan rates. See my "Concentration in banking and its effect on business loan rates", Rev. of Econ. and Stat., Aug., 1964.

makes competition in financial markets especially important. Credit imperfections typically lead to other market imperfections.

Without competition there is nothing to assure organizational or productive efficiency as well. Monopolistic firms that do not feel the threat of survival often become passive and lethargic, preferring to take their excess profits in the form of a "quiet-life" (short hours, excessive salaries, luxurious offices, inferior organization, etc.). In recent years economists have accumulated evidence to suggest that the social losses due to this kind of inefficiency are considerable (1).

Finally, a competitive environment induces firms to react quickly to changes in consumers' tastes, or to meet new demands with new products. Shifts in demand change profit opportunities, so that competitive firms operating with normal profits are forced to channel their efforts towards the new areas of profitability.

European financial markets need the stimulus of competition. Unaggressive, protected, enterprises which are neither penalized for poor performance nor rewarded for superior performance can hardly be expected to develop financial markets which will keep pace with the changing needs of rapidly expanding economic systems.

(1) See H. Leibenstein, "Allocative efficiency versus X - efficiency", Am. Econ. Rev., June, 1966.

Why Regulation ?

Competition in the sense of complete laissez faire is not a plausible objective in financial markets. Some regulation is desirable.

Although it is not impossible that the banking industry itself could develop a private system to accomplish the same ends as does government regulation, in practice the necessary degree of private initiative and cooperation is usually lacking.

First, and most important, government has a social responsibility to see to it that a viable and efficient payments system is developed and maintained. But even an efficient, convenient, payments system is of little value if the risks associated with using it are so high that people choose not to use it. A necessary concomitant of such a payments system, therefore, is absolute public confidence; and since commercial banks ordinarily render this service, it becomes a matter of maintaining the public's confidence in the banking system. This is the first and primary goal of any regulatory policy.

Second, by encouraging personal savings, financial markets play an important role in capital formation and consequently in economic growth. Banks and savings intermediaries provide an attractive, low-risk, method of saving, especially for small savers. Although these savers could in theory be subjected to a rule of caveat depositor and forced to search for savings institutions whose portfolio policies they approved of, in practice most savers do not possess the necessary degree of financial sophistication (even if the

necessary information were available). Once again, therefore, the goal of financial regulation is confidence - this time the confidence of savings depositors.

To achieve these goals, financial policy in Belgium, as in most other countries, has been directed towards preserving the solvency of financial institutions. Other than the kind of bankruptcies that are the consequence of severe depressions in economic activity, which in any case can only be dealt with by the timely intervention of the central bank in its role as "lender of last resort" and by the wise use of monetary and fiscal policy, the major hazards faced by banks and savings institutions are illiquidity, bad assets, mismanagement, and "overbanking". Regulatory policy typically attempts to protect institutions against these hazards by imposing strict capital and liquidity standards, on-the-spot asset examinations, restrictions on the kinds and amounts of assets institutions can hold, and by limiting general competition with restrictions on entry, branching, etc. Although some countries are more restrictive than others - Belgium is less restrictive than the United States with respect to entry and branching but more restrictive with respect to liquidity requirements, all countries have adopted an imposing array of regulations aimed at maintaining the solvency of financial institutions.

The obvious question is: do we need so many constraining regulations to maintain the confidence of depositors. Present regulatory policy achieves this goal by protecting not only depositors but investors' capital as well. A superior policy would be one that succeeded in maintaining confidence but at the same time subjected institutions to the trials of

the market place. It is, after all, only the "test of survival" which can guarantee the development of a socially efficient market system.

One regulatory tool which succeeds in maintaining depositors' confidence but also permits the market mechanism to function freely is "deposit insurance". Since 1935 the United States has had a highly successful system of deposit insurance. It is funded chiefly by premiums assessed on the private institutions themselves, although it has some government backing as well. The success of this system in maintaining confidence can be best seen by describing the recent failure of a small American bank in Covelo, California. Although the bankrupted bank was the only bank in town, "Covelo residents took it (the failure) with surprising calm" (1). With the exception of two depositors, our insurance system repaid all deposit losses in full within six days of the failure. Admittedly, we have not experienced bankruptcies of banks larger than 3 milliard of francs, but there is every reason to believe that the system is soundly conceived to maintain depositor confidence (2).

In sum, some sort of regulation is necessary to assure public confidence in the financial system. Nevertheless, this goal cannot begin to justify the extensive network of controls that has grown-up over the years. Supplemented by a sound system of deposit insurance (3), much regulation

(1) Wall street Journal, Pacific Coast Edition, April 19, 1965, 12.

(2) See Tussing, "The Case for Bank Failure", The Jour. of Law and Econ., October, 1967.

(3) See M. Mayer, "A Graduated Deposit Insurance Plan", 47 Rev. of Econ. and Stat. 114 (1965).

could be eliminated. Some capitalization requirements and some "character screening" of new entrants is still probably desirable, but little more.

The Evidence of Inadequate Competition

Assessing the degree of competition in an industry is typically difficult. With respect to banking, however, the evidence is unusually pervasive. This evidence consists of: (I) the low failure rate and general stability in the structure of the industry; (II) the persistence of firms of less than optimal scale; and (III) profit performance which is inconsistent with the results of multilateral market competition.

Stability of the banking structure. The Belgian banking structure shows remarkable stability in one respect but considerable instability in another respect. Although there are nearly eighty banks operating in Belgium, the three largest banks account for three-quarters of the total market, and this has been true since the end of World War II. Table I shows that the shares of the largest banks have been extremely stable for the past twenty years, in terms of both assets and bank offices. On the other hand, Table 2 suggests considerable entry and exit activity. From 1960 to 1967, for example, a total of eighteen new banks began operations, almost three a year; while twenty-one banks exited the industry through either merger or voluntary liquidation, or about three a year. On the basis of structural stability, therefore, it appears that there may be substantial competition among smaller banks but little competition among the largest banks.

TABLE I
CONCENTRATION IN BANKING *

	Percentage of total assets			Percentage of all bank offices	
	1945-50	1966-67	1966-67**	1945-50	1966-67
Largest bank	35.4	34.2	37.3	31.5	32.4
Largest two banks	58.2	60.0	65.3	61.8	61.2
Largest three banks	70.4	75.0	81.2	79.3	80.6
Largest five banks	75.0	81.5	89.6		

* Commission Bancaire, Rapport anniversaire 1935-1960,
and Rapport Annuels, 1965-68.

** Excluding Foreign Banks

TABLE 2
CHANGES IN BANKING STRUCTURE, 1945-67 * (All Banks)

	1945	1945-60	1960	1960-67	1967
Total number of banks	94		82		79
National banks	86		75		68
Foreign banks	8		7		11
New banks		13		18	
Mergers		16		15	
Liquidations		4		6	
Failures		5		0	

* Commission Bancaire, Rapports annuels, 1946-68.

A low failure rate also suggests the absence of competition. It is not clear from Table 2, however, what the rate of forced withdrawal has been in banking. The Commission Bancaire no doubt "converts" potential failures into either mergers or voluntary liquidations, making it impossible to determine exactly what "capital losses" were sustained through failure. Given the intense concern of the Commission Bancaire, it seems only prudent not to attach great importance to the absence of "official" failures in the period 1960-67 (1).

Scale Economies. In effectively competitive markets, firms of less than optimal size are eventually forced to leave the industry. Assuming competition, therefore, the skewness in the size distribution of Belgian banks suggests that there are little or no economies of scale in banking. Five Belgian banks have assets in excess of 10 billion Francs, while 44 banks have less than 750 million francs of assets. In addition, the average size of the largest three banks is more than 20 times that of the average size of the smallest 44 banks. Since large and small banks often operate side-by-side, we can draw only one of two conclusions: either there are no economies of scale, or there is little competition between large and small banks (2).

(1) It is hoped that the Commission Bancaire will make available more meaningful figures in the future. A study of the primary motivations for mergers and liquidations would be very illuminating.

(2) Although it is possible, even probable, that some small banks do an entirely different business than large banks so that they are not in "competition" with big banks, this possibility could hardly encompass all small banks.

Measuring scale economies in any industry is difficult. In banking it is even more difficult. The difference in product-mix between large and small banks may be substantial, so that comparing their respective cost curves may be analogous to comparing a French restaurant with a steel mill. In the absence of a more definitive study, however, we must rely on what is available. Table 3 presents evidence which clearly indicates the existence of at least some economies of scale in banking.

TABLE 3
ECONOMIES OF SCALE IN BANKING
(Banques constituées sous la forme de Société Anonyme *)

Banking size class by total assets (millions of B.F.)	Operating expenses/ Total assets		Operating expenses/ total revenue		Capital/ total assets
	1966	1967	1966	1967	1967-68
0 - 250	.0435	.0424	.4684	.4479	14.20
250 - 750	.0376	.0366	.4218	.4190	8.97
750 - 2,500	.0297	.0276	.3625	.3711	14.37
2,500 - 10,000	.0294	.0278	.4195	.4084	5.79
10,00 and over	.0284	.0271	.4340	.4246	4.45

* Commission Bancaire, Les Report Annuels, 1965-1969. In the jargon of the Commission Bancaire, operating expenses are "Frais généraux", total assets are "Actif total", total revenue is a bank's gross earnings, and capital is "Fonds propres" or "non exigible".

In industrial firms there may be many kinds of economies of scale: in production, distribution, research, selling, management, and capital costs. In banks there are various kinds as well. Table 3 attempts to measure two general types of economies in banking: "operating cost" and "financial" economies. "Operating cost" economies refer to operating costs (salaries and wages, advertising, etc., but not interest paid on deposits) per unit of output. "Financial economies" refer to the advantages which big banks may have in respect to capital requirements. Since large size usually brings greater diversification, big banks may need less capital relative to their liabilities, and this greater leverage may reduce capital costs (1).

Table 3 shows that economies of scale exist in both kinds of "costs". First, operating costs (frais généraux) per unit of assets and per unit of gross income (revenu total)

both show substantial operating economies up to a bank size of at least 750 to 2,500 millions of francs. Two different measures of output are presented because of the difficulty of defining bank output. For example, banks produce certain services for which there is no asset counterpart, such as trust and brokerage services. For this reason, a bank's gross income (revenu total) may better represent its output. Up to a bank size of 750 to 2,500 millions of francs, both measures indicate the existence of economies of scale. For larger size

(1) Although bank regulation exerts an important influence on capital requirements, such regulation may itself be a reflection of market realities, at least to some extent. In any case, there is clearly some benefit to large size in this respect, and, rather than ignore it, I have chosen to overlook the regulatory bias. More refined measures of financial economies are no doubt possible, but more available ones are not.

banks, however, the two measures differ. If output is defined as gross income, Table 3 shows operating cost diseconomies; if output is defined as total assets, it suggests a rather flat cost curve for banks of larger size.

Evidence of "financial" economies of scale is especially strong. Table 3 presents capital-to-asset ratios (fonds propres / actif total) By bank size which suggest that large banks enjoy the advantage of greater leverage. At least up to a size of 2,500 to 10,000 millions of francs banks are able to increase their leverage as they become larger. Somewhat surprising, however, is that all measures of economies of scale presented in Table 3 indicate that scale economies cease after reaching some size of less than 10,000 millions of francs.

Given these findings, it would appear that at least fifty banks operating in Belgium are inefficient, or are less than the optimum size. If vigorous competition existed between small and large banks, many of these inefficient banks would obviously be forced to withdraw from the market. As a considerable number of small banks continue to exist and prosper, it seems clear that very little competition exists between large and small banks.

Profit performance. The ability of a firm or industry to earn more than "normal" profits is a prime indicator of its insulation from competition. Although it is difficult to agree on what rate of profit is "normal", a reasonable approach is to compare profit rates among industries. A recent sample survey for the years 1967 and 1968 shows that the return on capital in most industries is around 5 or 6 per

cent (1). How does banking compare to other industries ?

TABLE 4

BANK PROFITABILITY ON CAPITAL

(Bénéfice net par rapport aux fonds propres des banques constituées dans la forme société anonyme, en pourcentage) *

Year	Bank size class by total assets (millions of B.F.)				
	0 - 250	250 - 1,000	1,000 - 10,000	10,000 and over	
1960	7.35	9.14	10.74	13.53	
1961	9.72	10.91	12.71	14.95	
1962	8.27	9.44	7.64	11.90	
1963	8.56	9.62	9.92	12.29	
1964	3.11	10.08	11.83	11.58	
1965	6.86	9.07	11.91	10.74	
=====					
Mean	7.31	9.71	10.79	12.50	
=====					
Bank size class by total assets (millions of B.F.)					
	0-250	250-750	750-2,500	2,500-10,000	10,000 and over
1966	3.96	4.88	9.22	10.67	11.19
1967	1.99	7.72	6.42	11.73	11.27
Mean	2.98	6.30	7.82	11.20	11.23

* Commission Bancaire, Les report annuels, 1960-68.

(1) Banque de Paris et des Pays-Bas Belgique, "Evolution de la rentabilité et de l'endettement des sociétés belges en 1968," Service d'études, Juin, 1969. The number of firms sampled in each industry is small, making these figures less than ideal.

Table 4 presents profit rates for banks by size class from 1960 through 1967. There are two striking aspects. The first is that large banks earn much higher profits than small banks. In recent years banks with assets greater than 2,500 millions of francs attained a rate of return on their capital almost four times higher than that earned by banks with assets of less than 250 millions of francs. The second aspect is that the rate of return in big banks has consistently surpassed by a wide margin the "normal" rate of return in Belgian industry. Rather than the usual five or six percent return on capital, large banks have earned more like ten to thirteen percent. These findings add impressive support to our earlier conclusions that, first, there is very little competition between small and large banks, and, second, there is a serious lack of competition among the large banks themselves. Large-bank profits are certainly higher than would be the case under more competitive conditions (1).

A final point of interest is that there is practically no difference in the profitability between large and very large banks. In three out of the last eight years (1960-67), banks in the 1,000 to 10,000 million-franc size class actually earned a slightly higher return on capital than did the giant banks. This similarity in profitability reinforces our earlier conclusion that economies of scale largely cease after banks reach a size of between 2,500 and 10,000 millions of francs.

In summary, the evidence suggests that banking is not a highly competitive industry. Although there is undoubtedly a considerable degree of competition at the margin, or with respect to the very small, highly inefficient banks, most banks of any size are immune from serious competitive threat.

Public and Private Restraints on Competition

The exceedingly high profitability of large banks, the structural stability of certain features of banking markets, and the continued existence of many banks of less than optimal scale are not difficult to explain. They arise because of an all-encompassing system of public regulation and supervision working in conjunction with a well-developed private market organization. Most of the public regulation appears under the guise of protecting depositors and maintaining the solvency of banks, while much of the private organization is more informal. In many cases, government regulation actually encourages private organization which restricts competition, once again under the guise of preventing "excessive" competition. An example is the familiar cartel arrangement which restricts price competition for savings deposits. The point, however, is not that banks make a conscious effort to arrange conspiracies in restraint of trade, but that public regulation has the express purpose and private organization has the incidental effect of restraining competition.

Public regulation. Although public regulation restrains competition in many ways, two types of regulation stand out immediately as among the most important: (1) the restrictions against price competition, and (2) the limitations against entry, "broadly interpreted".

Public regulation, of course, does not directly control all forms of price competition. Bankers are free, at least theoretically, to set whatever loan rates they believe is appropriate. It is with respect to inputs - or deposits - that public regulation exercises its most restrictive influence.

Bankers are not free to pay whatever interest rate they wish for deposits. Rates paid on demand deposits are strictly controlled; and rates on savings deposits, although not as formally regulated, are just as effectively controlled. If the restrictive effects of this regulation extended only to deposits, it would be serious enough. But control of input prices often has the peripheral effect of affecting competition in the output market as well. Numerous American antitrust cases have discovered that anti-competitive pricing systems for output are frequently developed and maintained through control of input prices (1). Since the interest cost of attracting and holding deposits is one of the most important bank expenses, the condition of equal costs in this sense encourages "conscious parallelism" in the output market- or fosters tacit agreement to follow the leadership of the largest banks in the credit markets.

The inability of banks to compete in terms of price has also resulted in a proliferation of undesirable forms of non-price rivalry. Luxurious bank offices, excessive branching and excess capacity, and advertising expenditures have become alternative forms of competitive rivalry. Since it is unlikely that these alternative "services" provide consumers with a benefit proportional to the costs of furnishing them, non-price competition has probably resulted in higher bank operating costs than would prevail under conditions of price competition. In addition, some forms of non-price rivalry, such as advertising, may result in significant

(1) U.S. v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940);
American Tobacco Co. v. U.S., 328 U.S. 781 (1946);
Pevely Dairy Co. v. U.S., 178 F2d 383 (8th Cir. 1949).

product differentiation, which could create a serious barrier to competition through new entry (1).

The second type of regulation which has had an important impact on competition are the various limitations on entry. Entry can come from several sources. New banks may be formed to compete with existing banks, or existing nonbank financial institutions can enter banking markets directly by offering identical products. With respect to the latter, regulations severely limit direct competition between banks and **nonbank** financial institutions. For example, **nonbank** financial institutions cannot provide demand deposits and short-term business credit, while banks cannot provide long-term credit. Thus, severe portfolio restrictions on both banks and financial intermediaries greatly limits competition between them (2).

Private organization. Public regulation is not the only source of constraint on competition. Private organization, of both a formal and informal character, also exercises an important constraint, and this type of organization is often encouraged rather than discouraged by governmental authorities. Once again, I emphasize that in most cases there has been no conscious effort to restrain trade. Rather, the restraint on competition has been an incidental - although important - effect of these arrangements.

-
- (1) See T. Wilson and W. Commanor, "Advertising, Market Structure, and Performance", Rev. of Econ. and Stat., Nov., 1967.
 - (2) See A. Lamfalussy, "La politique monétaire en présence des circuits financiers cloisonnés", Recherches Économiques de Louvain, Juin, 1967.

Banking, like other industries, has its trade associations. These associations often perform valuable informational and educational services. They also provide a ready forum to resolve conflict. Since competition is a form of conflict, trade associations have at least the potential of permitting competitive conflicts to be worked-out in terms of words rather than market performance. This danger seems especially real in markets which are tightly oligopolistic, like in banking where five banks account for about 90 % of all assets in Belgian banks. I am not nearly so cynical as was Adam Smith, however, who said: "People of the same trade seldom meet together for merriment and diversion, but that the conversation ends in a conspiracy against the public or in some contrivance to raise prices".

Other forms of private restraints are more formal. Perhaps the most serious of these are the constraints incidental to the holding company form of organization. All of the largest Belgian banks are members of gigantic holding company organizations, which include both financial and nonfinancial enterprises (1). These organizations offer numerous possibilities for restraining competition.

First, holding companies serve to unite the diverse interests of potential competitors. Banks, insurance companies, savings institutions, and even steel companies may be joined together in a common purpose. Holding companies permit close contact between top management, either directly or through interlocking - directorships. Where the scope of the market is small, as in Belgium, there may be few likely potential entrants into banking, so that eliminating the entry threat of

(1) Centre de recherche et d'information socio-politiques, Morphologie des Groupes Financiers, 1966.

these firms through holding company associations could be a serious restraint on competition. For tightly oligopolistic industries, potential entry is one of the few market mechanism capable of effectively limiting market power (1).

Second, to the extent that certain business as are tied to banks through holding companies, there does not exist real competition between the banks for the business of these companies. There is no way of knowing just how substantial this problem is in Belgium, although it does not appear to be trivial. Nor do the competitive effects of tying banks to nonbanking enterprises stop with banking. They extend to other markets as well. In fact, holding companies raise a competitive issue which has had a long history in American antitrust law: that of tying arrangements.

A tying arrangement, in general, is a formal or informal agreement between a seller and buyer where the seller agrees to sell one product but only on the condition that the buyer also agrees to purchase a different (tied) product, or at least agrees not to purchase that product from any other firm. Put in the context of banking, the problem is that banks may use their control over short-term credit to insist or "strongly suggest" that borrowers who want continued access to credit should also use the services or products of their holding company affiliates. Since many businesses depend on bank credit for their economic existence, this practice could also in the long run substantially reduce or eliminate competition in other industries--specifically, the industries of bank holding company affiliates (2).

(1) See F.T.C. v. Procter and Gamble Co., 386 U.S. 568 (1967).

(2) See F. Edwards, "Tie-in Sales in Banking and One-bank Holding Companies", The Antitrust Bulletin, Fall, 1969.

Thus, the combination of public regulation and private institutional and organizational arrangements goes a long way towards explaining the lack of competitive market performance in Belgian banking, and the same is probably true for other European financial markets.

Improving Performance Through Regulation.

Improving performance in banking and other financial markets is not an easy task. There are three strategies which can be employed towards this end. They are: (I) altering the market structure, (II) changing regulatory policy, and (III) prohibiting certain types of private organization. Some change in all three may be necessary in the case of banking.

Small, marginal, changes in banking structure are not likely to have a significant impact on bank performance. For example, prohibiting mergers among large banks or even prohibiting large banks from opening additional branch offices will not alter market structure either very much or very quickly. These tools are more appropriately used to prevent the development of excessive concentration rather than to rectify an already concentrated structure, as in Belgium.

To effectively improve bank performance through structural change would, unfortunately, necessitate rather drastic reform. Specifically, the dissolution of large banks into smaller banks. Although drastic, this action could create a market structure more closely resembling the atomistic competitive structure of classical economics. A policy of dissolution is not without problems, however. If there are economies of scale in banking, and surely there are some, dissolution may result in suboptimal banks, with a consequent loss in

productive efficiency.

Here we may be able to draw some guidance from our previous findings on economies of scale. Tables 3 and 4, it will be remembered, indicated that most economies of large size disappear after reaching a bank size of 10,000 millions of francs. This suggests a rather provocative structural reorganization: breaking-up the largest banks into many banks of 10,000 million francs. The largest five Belgian banks account for about 400,000 million francs of bank assets. If these five banks were converted by dissolution into some forty banks of optimum size, the resulting market structure would very much approximate the classical competitive structure.

No responsible researcher or policy-maker can recommend such a drastic reorganization without a good deal of hesitation, however. My investigation of scale economies is admittedly simplistic, and very large banks may serve social purposes not considered in this study. It seems desirable, nevertheless, that Belgian regulatory authorities at least begin to seek better answers to these questions (1).

Given the difficulty of significantly altering the banking structure, substantial improvements in performance can, I believe, still be made by modifying aspects of regulatory policy and private organization.

(1) The Commission Bancaire is presently undertaking the first study of economies of scale ever done on Belgian banks. Hopefully, this study will be more penetrating and informative and will be available for public consumption.

First, a system of deposit insurance should be instituted. By guaranteeing the safety of deposits in small and medium-sized banks, deposit insurance will encourage depositors to view these banks as identical to big banks, despite the larger resources and the superior diversification of the latter. The result should be to enlarge the demand for the services of these banks and give them more competitive equality with the very large banks. In addition, a system of deposit insurance would permit regulatory changes designed to encourage competition.

Second, a policy of free entry is necessary. With the exception of the case where entry is denied because of poor character (or potential criminal abuse), any person with the required capital should be permitted to form a bank (1). In addition, the artificial legal barriers which limit the size of the market by preventing nonbank financial institutions from competing with banks should be discarded. In particular, savings institutions should be permitted to accept demand deposits and extend credit similar to that of banks (and vice versa). Greater competition among the different types of established financial institutions would expand the market and create a market structure more conducive to competitive performance. Finally, foreign banks should be given continued access to Belgian markets.

Third, supervision needs to be modified to permit banks greater freedom to establish their own credit and risk standards. By permitting banks to experiment with new types of credit or to specialize in particular lines, non-price compe-

(1) Table 2, presented earlier, indicates that the Commission Bancaire is already pursuing a liberal entry policy with respect to the chartering of new small banks.

tition could assume a more constructive character. Instead of excessive advertising and promotion of identical products, banks may make a serious effort to develop and market new products and services.

Fourth, restrictions on the interest rates paid on deposits should be eliminated, both on demand deposits and on savings deposits. Rather than supporting cartel rate-fixing, public policy should encourage the most efficient banks to pay the highest rates.

In almost every country with which I am acquainted limitations on interest payments stem from a fear that rate competition will result in increased pressure on earnings and thus lead banks to make imprudent loans and investments. This argument is both misleading and wrong. If increased rate competition does reduce the overall quality of bank loans and investments, and if this condition does lead to additional bank failures, such failures would have to be judged as due to bad management. Since the express purpose of competition is to weed out the inefficient and incompetent, this possibility is hardly undesirable (providing the necessary safeguards discussed earlier have already been adopted). In addition, recent empirical research in the United States indicates that this "quality deterioration" argument is simply wrong. Studies of banks prior to legal restrictions on interest payments. (e.g. 1930's) have shown that the payment of interest on demand deposits did not lead banks to assume greater risks (1).

Fifth, the holding company form of organization needs to be carefully scrutinized to determine if it enhances or

(1) G. Benston, "Interest Payments on Demand Deposits and Bank Investment Behavior", Jour. of Pol. Econ., October, 1964.

diminishes public welfare. Each country faces different economic problems, so that it is impossible to generalize and apply one country's experience to another. Still, given the small size of the Belgian economy, the anticompetitive impact of giant holding companies may not be trivial. Further, many economists are very sceptical of the purported economic advantages of this form of organization (1).

Finally, some sort of antitrust policy should be applied to banks and financial institutions. Mergers, affiliations (through either stock control or interlocking directorates), trade association activities, and all types of agreements among financial institutions should be subject to the same antitrust standards as are nonfinancial businesses. There is no reason to exempt financial institutions from the social and economic standards generally considered appropriate for other industries (2).

These are not small changes in policy. Although the social benefits appear to merit these changes, they are certain to encounter vigorous opposition. The inefficient and incompetent always fear free competition; large firms are always reluctant to give-up dominant market positions; and almost all governments wish to avoid changes which carry even a remote possibility of failure. Indeed, in Belgium, as in other European countries, governments are important direct participants in financial markets (3). As such, they are

(1) See my "The One-Bank Holding Company Conglomerate: Analysis and Evaluation", The Vanderbilt Law Review, Nov., 1969.

(2) See, however, U.S. v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1954).

(3) In Belgium, for example, government institutions account for approximately half of the savings deposits held in financial institutions.

unlikely to indorse policy changes which may eventually make it more costly for them to acquire funds (1). One wonders whether it is either necessary or desirable under contemporary economic conditions for governments to participate directly in financial markets (2). Social objectives might be accomplished better through a soundly conceived private incentive system, created and maintained by government.

Competition Extended

The proceeding has been a plea for the adoption of a competitive policy. It does not assure the success of this policy.

There are two obvious outcomes. Either such a policy will foster competitive markets in the future, or freedom to compete will result in increasing market concentration as the larger, more efficient, banks drive their smaller rivals into liquidation and merger.

-
- (1) To the extent that government is able ^{to} borrow private savings at an interest rate below what it would have to pay under competitive conditions, the effect is equivalent to a higher income tax. The effect is undoubtedly regressive as well.
- (2) I do not refer, of course, to monetary policy. Some intervention will always be necessary for purposes of monetary policy. All of the above policy recommendations have been made only after also considering their implications for monetary policy. More competition would, I believe, make monetary policy more rather than less effective. Lack of competition reduces substitutability between the various financial assets, and less substitutability between assets reduces the impact of monetary policy on rates of interest. See S. Peltzman, "The banking structure and the transmission of monetary policy", Journal of Finance, June, 1969; and W. Silber, "Portfolio Substitutability, Regulations and Monetary Policy", Quarterly Journal of Economics, May, 1969.

Whether the result is more competition or more concentration, the outcome will be a decided improvement over present markets. If future markets become more competitive, all of the benefits discussed earlier will be reaped; if the future brings greater concentration and fewer banks, the social gain will be the elimination of inefficient and suboptimal banks. Greater concentration or fewer banks does not represent a diminishment of competition over present market conditions. Evidence presented earlier suggests that there is currently very little or no competition between large and small banks.

If adopting a policy of free market competition eventually leads to an explicitly monopolistic banking market, what then? There are probably two possibilities. The first is rather grim and unimaginative: nationalization of the banks (or regulation which is effectively the same). This alternative has already been taken in countries as diverse as France and India. Government control as opposed to private monopoly, however, is not usually a solution to the problems of misallocation, inefficiency, and innovational backwardness. In fact, there is much reason to believe that market performance will be worse rather than better (1).

The second possibility is that a fully integrated, freely competitive, European economic community will negate the need for competitive markets within national boundaries. An integrated European capital market would expand the size of banking markets so that the large firm size needed for internal efficiency may once again be compatible with competitive

(1) For an interesting discussion of this possibility, see J.K. Galbraith, The New Industrial State (Hamish Hamilton Ltd. 1967), pp.98-108.

markets (1).

Assuming the happy development of a free European financial market, will adopting the competitive policy recommended in this paper be of any value ? If large size is truly necessary for internal efficiency, a competitive European banking market will also mean the demise of the small bank. Thus, by subjecting Belgian banks to the test of the market place now, regulatory authorities can smooth the way for their successful participation in a larger European market. If small Belgian banks must disappear, perhaps it is better for Belgium itself to determine the circumstances of their demise.

Finally, adopting the policy recommendations which I have suggested will provide more assurance that an integrated European financial market will result in greater competition. Perpetuating the present system of public and private restraints on competition is the surest way to guarantee that competition will not be increased. Unlike many less regulated industries, banking (performance) will not improve automatically with the development of a European market. At some point a regulatory policy which permits and fosters competition must also be instituted. The prospect of the European Economic Community adopting such a policy would be immeasurably improved if individual countries could themselves create a regulatory climate conducive to competition.

(1) Perhaps regulators, economists, sociologists, and even psychologists will someday also develop an incentive system for management which can serve as a substitute for the competitive market. At present, however, we dare not hope for too much in this direction.

Much of the immediately preceding discussion has been directed at a hypothetical eventuality: that the acceptance by Belgian regulatory authorities of a competitive banking policy will not ultimately result in greater competition unless there is also a concomitant development of a European financial market. Contrary to many observers, I believe this to be a possibility and not an inevitability, and in the spirit of my paper would allow the market to decide the issue.
