

# Did Lloyds/HBOS mark the failure of an enduring economics-based system of merger regulation?

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## Abstract

*This article asks whether the merger of Lloyds TSB and Halifax Bank of Scotland (HBOS) in 2008, on public interest grounds, marked the failure of an enduring economics-based system of merger regulation. It argues that, far from marking a failure, the Lloyds/HBOS merger highlights the importance of only allowing public interest interventions on exceptional grounds in specific industries. Economics-based merger control is transparent and preferable to general public interest assessments, which are unpredictable and open to abuse. Concerns raised which support arguments for greater political interventions can be more effectively addressed in other ways.*

## Introduction

In September 2008, Lloyds TSB and HBOS were allowed to merge into the Lloyds Banking Group, in a deal brokered by the UK government. For the first time since the Enterprise Act 2002 came into force, the UK government used its public interest powers to allow a merger which was opposed by the Office of Fair Trading (OFT) on competition grounds. The Enterprise Act had created a system of regulation which assessed mergers purely on competition grounds. It removed the scope for political interventions on public interest grounds from general merger assessment and restricted them to cases concerning national security and plurality of the media. In order to allow the Lloyds merger on public interest grounds, the Secretary of State for business had to create a new public interest ground with the consent of Parliament. In light of this case and other political pressures in the wake of the financial crisis, some have suggested that the UK may have gone too far in creating an ‘unduly purist economic enforcement’ regime.<sup>1</sup> The time may have come to consider whether it would be beneficial to allow broader political interventions in merger control, on non-competition grounds. Such interventions would also allow the government to block foreign acquisitions of British firms, considered by many to be damaging. An example of this is the acquisition of Cadbury plc by the American firm, Kraft Inc. in 2010.

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1 S Wilks, “The impact of the recession on competition policy: amending the economic constitution” (2009) 16 *International Journal of Economics of Business* 269, discussing the French Loi de Modernisation de l’Economie, 2008, albeit as the more “radical” option; M McElwee, “Politics and the UK merger control process: the public interest exceptions and other collision points” (2010) 9 *Competition Law Journal* 77.

The state's intervention to approve the Lloyds/HBOS merger on public interest grounds can be viewed as a Polanyian protective counter-move. Karl Polanyi argued that, "constant action on the part of the government is needed to ensure the functioning of free markets without fatal harm to the community".<sup>2</sup> These counter-moves, he maintained, blunted the "self-destructive" trends of the market and empowered the state in its roles as regulator of the economy and guarantor of basic social welfare.<sup>3</sup> In the present case study, this self-destructive trend is characterised by the dangerous consequences of permitting HBOS to collapse, thought at the time to be an inevitable result of the merger being blocked on competition grounds. Polanyi's verdict on competition in 1928 – when there was a notable absence of competition law rules – was that it had been "crushed by its creature, monopoly".<sup>4</sup> Yet competition law can in itself be viewed as a form of counter-move, seeking to protect markets from monopoly and collective market power. Indeed, the enforcement in Europe of Article 102 TFEU (Treaty of the Functioning of the EU, the abuse of dominance prohibition) is sometimes thought to also protect competitors. In contrast to *Chicago School* economics, which is the dominant influence in antitrust, the concern for competitors stems from the influence of *ordoliberalism* which originated in Freiburg in the 1930s. It embraced the free market but felt that that was not in itself sufficient. Economic freedom should be protected from control by private economic power. This was to prevent the private economic power from being turned into political power, as had been the case in Nazi Germany through the misuse of the iron and steel industries.<sup>5</sup> Competition policy can also be viewed as embedding the market, especially in focusing on consumer welfare and choice.<sup>6</sup> There is therefore scope for accommodating competition policy within the Polanyian framework. However, competition law protects against a much narrower set of self-destructive forces than those envisaged by Polanyi, and is shaped almost entirely by economic theory. It is closer to *Gesellschaft* than *Gemeinschaft*. It also seeks to ensure the effective functioning of markets and therefore entrenches the market paradigm. The issue is therefore the extent to which state intervention is necessary in merger regulation in order to afford adequate protection to society.

The purpose of this article is to consider whether the Lloyds/HBOS merger marks the failure of an enduring economics-based system of merger regulation, demonstrating the need for more political interventions on public interest grounds. First, it will review the shift in UK merger control from public interest to a competition-only assessment, noting the narrow retained role for political intervention on public interest grounds. Second, it will set out the circumstances surrounding the merger, the intervention of the Secretary of State and the recommendation of the OFT. It will also identify some of the more general arguments for intervention on public interest grounds, especially in light of Kraft's acquisition of Cadbury in 2010. Third, it will assess whether there is an argument for broader public interest considerations in merger control. This will involve looking at

2 G Dale, "Karl Polanyi's *The Great Transformation*: perverse effects, protectionism and *Gemeinschaft*" (2008) 37 *Economy and Society* 495, p. 499.

3 K Polanyi, *The Great Transformation: The political and economic origins of our time* (Boston, MA: Beacon Press 1957), p. 76.

4 Dale, "Karl Polanyi", n. 2 above, p. 497.

5 L L Gormsen, "The conflict between economic freedom and consumer welfare in the modernisation of Article 82 EC" (2007) 3 *ECJ* 329. For a discussion of German industry's role in the rise of the Nazi party, see D Jeffreys, *Hell's Cartel: I G Farben and the making of Hitler's war machine* (London: Bloomsbury 2008). See also Pinar Akman's arguments that the influence of ordoliberalism has been overstated and that the drafters of Article 102 TFEU were mainly concerned with increasing efficiency: P Akman, "Searching for the long-lost soul of Article 82 EC" (2009) 29 *OJLS* 267.

6 G Krippner et al., "Polanyi symposium: a conversion on embeddedness" (2004) 2 *Socio-Economic Review* 109.

whether the justification for intervention in the Lloyds/HBOS merger could also apply to mergers in other industries, and if the other concerns raised would be well served by public interest interventions. The article argues that, far from marking the failure of economics-based merger control, Lloyds/HBOS highlights the importance of restricting political interventions on public interest grounds to exceptional circumstances in specific industries. Arguments in favour of greater political intervention either relate to the characteristics of a specific industry, like banking, or can be addressed more effectively in other ways.

### From public interest to economics-based competition assessment

Under the Fair Trading Act 1973, merger references were made to the Monopolies and Mergers Commission (MMC) by the Secretary of State. The MMC would determine whether a merger situation qualifying for investigation had been created and, if so, “whether the creation of that situation operates, or may be expected to operate against the public interest” (s. 69). A recommendation was then made to the Secretary of State specifying the particular effects, adverse to the public interest, which the merger might raise. He would then determine how these adverse effects should be remedied, in blocking the merger or requiring divestitures. The Secretary of State could also “accept from such of the parties concerned as he considers appropriate undertakings to take specific action which the Secretary of State considers appropriate to remedy or prevent the effects adverse to the public interest” (s. 75G).

The concept of “public interest” was carried from the Monopolies and Restrictive Practices (Inquiry and Control) Act 1948. As Scott et al. note, “[s]uch guidance on interpretation of the phrase as the 1948 Act did offer was expressed at such a level of generality as to amount to an invitation to take into account anything that might seem relevant”.<sup>7</sup> The early merger regime was criticised for inconsistent outcomes, apparently arbitrary criteria used to decide each case, and for political interventions on non-competition grounds.<sup>8</sup> Between 1973 and 2001, Secretaries of State acted contrary to advice received from the Director General of Fair Trading on 31 occasions.<sup>9</sup> Some of the more absurd outcomes of this included how “some Secretaries of State [had] been ‘softer’ on merger control”, with the consequence that legal practitioners adjusted their advice to clients accordingly.<sup>10</sup> A relatively recent example of non-competition grounds was the “Lilley doctrine”, under which an acquisition should be closely scrutinised if the acquirer was a state-owned foreign firm.<sup>11</sup> This was announced by Peter Lilley, Secretary of State for Trade and Industry in 1990. A small number of references were made to the Competition Commission (CC) on this basis but none resulted in the merger being blocked.<sup>12</sup>

There had long been resistance to defining public interest out of fear this would lead to ‘undesirable rigidity’ in the MMC’s inquiries.<sup>13</sup> Although only a small proportion of all mergers were referred to the Commission, it was very hard for firms to predict when a merger would be blocked. In 1968 Rowley noted:

7 A Scott, M Hviid and B Lyons, *Merger Control in the United Kingdom* (Oxford: OUP 2006), p. 5.

8 C Rowley, “Mergers and public policy in Great Britain” (1968) 11 *Journal of Law and Economics* 83; T Ellis, “A survey of the government control of mergers in the United Kingdom” (1971) 22 *Northern Ireland Legal Quarterly* 251.

9 S Wilks, *In the Public Interest: Competition policy and the Monopolies and Mergers Commission* (Manchester: MUP 1999), p. 226.

10 *Ibid.* pp. 226–7.

11 *Ibid.* p. 226.

12 McElwee, “Politics and the UK merger control process”, n. 1 above, p. 80.

13 C K Rowley, “Mergers and public policy in Great Britain” (1968) 11 *Journal of Law and Economics* 75, p. 82.

The Commission has demonstrated its willingness to inquire into merger references without openly committing itself to a specific philosophy. Indeed, the chairman of the Commission . . . refused to be drawn upon the merger philosophy of the Commission: “It is enshrined in the reports which we have published. You must read these. Each case is different.”<sup>14</sup>

Public interest encompassed non-competition considerations which ran counter to an objective evaluation of whether a merger was likely to reduce the welfare of consumers in a given market. The lack of transparency and predictability risked deterring mergers and acquisitions which were beneficial to the economy.

However, in many respects the merger control regime set out in the Enterprise Act 2002 had already existed in practice for some years.<sup>15</sup> By the 1990s references were generally cleared by the MMC, unless they raised competition concerns.<sup>16</sup> A report on takeovers and mergers by the Trade and Industry Committee in November 1991 noted that:

While the emphasis on competition as the main criterion comes from the *Fair Trading Act 1973*, competition was given more prominence in 1984 when the then Secretary of State for Trade and Industry, Mr Norman Tebbit, announced that “references to the Monopolies and Mergers Commission (MMC) would be made primarily, but not exclusively, on competition grounds, taking into account the international dimension of competition.” Since then only six out of 74 references have been made to the MMC on non-competition grounds.<sup>17</sup>

British governments had taken on board years of criticism in connection with public interest and had more generally moved towards free market policies.<sup>18</sup> The dominant consideration for mergers had become promoting effective competition and the interests of consumers, but there remained a layer of political involvement in the assessment process.

The Enterprise Act put an end to “substantial room for the exercise of political preferences”<sup>19</sup> and set out an economics-based test for mergers. In all but exceptional cases, the quasi-independent OFT, rather than the Secretary of State, became responsible for referring mergers to the new CC. The new substantive test became whether a relevant merger situation “has resulted, or may be expected to result, in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services”<sup>20</sup> (the SLC test). While the SLC test is not defined within the Enterprise Act, guidance is published by the OFT and CC.<sup>21</sup> The competition authorities examine the prospect of three main factors which could lead to an SLC. *Unilateral effects* arise where there is rivalry between the two firms which would be removed if they merged. *Coordinated effects* arise where the merger increases the ability of firms within the market to coordinate their behaviour so as to raise prices: essentially, tacit collusion. *Vertical or conglomerate effects* arise where a merger between two firms at different levels of the production process, or in entirely different markets, can cause its

14 Rowley, “Mergers and public policy”, n. 13 above, pp. 83, 130.

15 McElwee, “Politics and the UK merger control process”, n. 1 above, p. 79.

16 Scott et al., *Merger Control*, n. 7 above, p. 6.

17 Trade and Industry Committee, *First Report: Takeovers and mergers* (Norwich: The Stationery Office 1991) HC Paper No. 90 (Session 1991/2), para. 223. Discussed in House of Commons Briefing Paper, *Takeovers: the “public interest test”* (4 August 2010) SN/BT/5374.

18 S Goodman, “Steady as she goes: the Enterprise Act 2002 charts a familiar course for UK merger control” (2003) 24 *ECLR* 331; A Scott, *The Evolution of Competition Law and Policy in the United Kingdom*, LSE Law, Society and Economy Working Paper (unpublished manuscript 2009).

19 Wilks, *In the Public Interest*, n. 9 above, p. 228.

20 Enterprise Act 2002, s. 22(1)(b).

21 The latest guidelines are published jointly by the OFT and CC: *Merger Assessment Guidelines* (September 2010) CC2 (revised) and OFT 1254.

presence in one market to reduce rivalry in another. No reference is necessary where “any relevant customer benefits . . . outweigh the substantial lessening of competition concerned and any [attributable] adverse effects”.<sup>22</sup> These include greater innovation, lower prices, higher quality or greater choice as a result of the merger. Strong customer buying power is also a relevant factor. The OFT must obtain and review information relating to mergers on UK markets. It is under a duty to refer to the CC any completed or anticipated relevant merger situation, which evinces an SLC. The OFT can negotiate undertakings with the parties to the merger in lieu of a reference where appropriate. The CC will respond to a merger reference by conducting an in-depth investigation. It has no power to undertake an investigation on its own initiative. The Competition Appeal Tribunal performs a judicial review function in respect of merger decisions.

The Secretary of State does retain a limited role under the current merger regime. Under s. 57(1), the OFT has a duty to notify the Secretary of State, in any case where it is considering referring a merger to the CC, of any matter it believes to relate to special public interest considerations. Section 44 also gives the Secretary of State the power to intervene in cases where a relevant merger situation raises public interest issues. These public interest issues were restricted by s. 58 to just two: national security and the media. The latter concerns the accurate presentation of news, free expression of opinion and sufficient plurality of views.<sup>23</sup> However, the Secretary of State can under s. 42 intervene on public interest grounds where the consideration “is not specified [in s. 58] but, in the opinion of the Secretary of State ought to be so specified”. Such an order must be approved by Parliament under s. 42(8)(b). Where the Secretary of State chooses to intervene, the OFT (or OFCOM in media cases) will provide him or her with a report containing their advice on the relevant considerations. Crucially, the Secretary of State is bound by the recommendations of the OFT in relation to the competition matters, but not in relation to the public interest considerations. He or she may then decide to refer the merger to the CC. The Secretary of State can also accept from the parties concerned any undertakings considered appropriate in order to remedy, mitigate or prevent any of the effects adverse to the public interest which may result (Schedule 7). However, in the present case the Secretary of State did not seek undertakings which might remedy some of the competition concerns.

### The Lloyds/HBOS merger and other arguments for public interest interventions

In September 2008, the UK government pushed for the acquisition of HBOS plc by Lloyds TSB Group Ltd for £12.2bn. Lloyds TSB was chosen because of its relative strength in the wake of the banking crisis and because the merger would not have a European dimension and would therefore be subject to UK merger regulation.<sup>24</sup> This is significant because the government was unlikely to have ensured that the merger would have been allowed if it had

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22 Enterprise Act 2002, ss. 21(2)(b) and 33(2)(c).

23 For example, in November 2006 the Competition Commission provisionally found that Sky Broadcasting Group's acquired 17.9% share of ITV plc created a substantial lessening of competition and operated against the public interest due to concerns over media plurality. See D Geey and A Chanter, “*British Sky Broadcasting Group PLC v Competition Commission: broadcasting and control over ITV – SKY reaches its limit*” (2010) 21 *Entertainment Law Review* 150.

24 Both banks achieved over two-thirds of their UK turnover within the UK and so the transaction was not subject to EC merger control.

been assessed by the European Commission.<sup>25</sup> While the Secretary of State can issue a European Intervention Notice on public interest grounds, he or she is not able to override a prohibition of a merger by the European Commission.<sup>26</sup> The Secretary of State used his power under s. 42 Enterprise Act to create a new public interest ground, “maintaining the stability of the UK financial system”.<sup>27</sup>

The OFT issued a report in October 2008 in which it concluded that it was likely the merger would result in a substantial lessening of competition in relation to personal current accounts, banking services provided to small and medium-sized businesses and mortgages.<sup>28</sup> It recommended that the merger should be referred to the CC for closer scrutiny. The OFT received a large number of submissions from stakeholders including the Bank of England, the Financial Services Authority, the Treasury and the Scottish Government. It summarised them in the following way:

The majority of third parties considered that, in light of the extraordinary conditions in the financial markets, the merger would benefit financial stability, and was therefore in the public interest. However, some third parties expressed concerns about the impact of the merger on competition in the medium to long term. Concerns were also specifically expressed that the impact of the merger in Scotland would be against the public interest.<sup>29</sup>

It concluded that, not only did customer benefits in relation to the creation of the relevant merger situation not outweigh the SLC, but that its competition concerns were so serious that it would not be appropriate to deal with the matter by way of undertakings.<sup>30</sup> While the OFT did not entirely rule out the possibility of developing structural remedies through further engagement with the parties, it noted that in the attempted merger between Lloyds TSB and Abbey National in 2001, the CC could not find any structural or behavioural remedies which it considered sufficient to alleviate its competition concerns.<sup>31</sup>

The Secretary of State ignored this recommendation and forced the merger through on public interest grounds without the CC having a chance to consider its implications for competition. He did this on the basis of s. 45 of the Act, finding that the benefits of the merger for the stability of the UK financial system outweighed the likely anti-competitive outcomes. A statement published by the Department for Business Innovation and Skills (BIS) stated:

In the light of extraordinary stress in the worldwide financial markets at the time of the proposed Lloyds/HBOS merger, and the systemic importance of HBOS plc to the UK banking system, the Secretary of State considered that there was a need to act quickly and intervene in the proposed merger given the serious threat to the stability of the UK financial system.<sup>32</sup>

25 C Pouncey and I Bukovics, “Merger control credit crunch style: UK government intervention in the Lloyds/HBOS merger” (2009) 30 *European Competition Law Review* 67; McElwee, “Politics and the UK merger control process”, n. 1 above, p. 88.

26 *Ibid.* p. 69.

27 BIS, *The Creation of a New Public Interest Consideration on Stability of the UK Financial System* (Norwich: The Stationery Office 2008).

28 OFT, *Anticipated Acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform* (London: OFT October 2008), para. 2.

29 *Ibid.* para. 19.

30 *Ibid.* para. 384.

31 *Ibid.* para. 380.

32 BIS, *The Creation of a new Public Interest Consideration*, n. 27 above, p. 1.

The newly created Lloyds Banking Group now controls around 33 per cent of UK Current Accounts and 30 per cent of UK mortgages. It holds around 40–50 per cent of small business services in Scotland. In addition, in a study conducted by the OFT in July 2008, the market for current accounts was found to have a number of competition concerns which were compounded by high barriers to new entry and reluctance by customers to switch bank accounts.<sup>33</sup> Indeed, when Lloyds had been blocked from acquiring Abbey National in 2001, the market shares at stake were lower than in Lloyds/HBOS.<sup>34</sup>

The Lloyds TSB/HBOS merger occurred in the wake of the financial crisis in which there was a real concern that the banking sector would collapse. The government issued guarantees for depositors, and nationalised banks including Northern Rock and Bradford and Bingley (B&B). B&B was sold to the Santander Group at around the same time as the Lloyds/HBOS merger.

The stability of financial markets provides just one justification for political intervention on public interest grounds. There are arguments for intervention on other grounds which are summarised by Whish.<sup>35</sup> First, mergers may be driven by “short-termism”: to make a quick profit where the merger may not be in either firm’s long-term interest. In this respect, the decision of shareholders will not always be the best result. Indeed, around half of all mergers may actually reduce the value of the firm.<sup>36</sup> Second, mergers create concentrations of wealth which may not be socially desirable. Third, they frequently lead to factory closures and redundancies, sometimes in regions already suffering from high levels of unemployment. Fourth, foreign acquisitions constitute “selling the crown jewels” with the decision-making process for British firms being taken abroad. The UK’s comparatively liberal acquisition laws mean that it is a lot harder for British firms to acquire foreign businesses than it is for them to come under foreign control. Lastly, there are certain sectors, such as the media, which are considered especially sensitive and cannot therefore be regulated purely on competition grounds.

The controversial acquisition in 2010 of British chocolate manufacturer Cadbury PLC by the American confectioner Kraft Inc. highlighted both the foreign acquisition and employment concerns.<sup>37</sup> Cadbury was considered one of the last great British companies to fall into foreign ownership. In addition, Kraft confirmed the closure of Cadbury’s Somerdale factory with the loss of 400 jobs once the acquisition was complete, having indicated during the takeover that the jobs would be safe.<sup>38</sup> One of the most vocal critics at the time was Vince Cable, who later that year became Business Secretary under the Coalition government between the Conservatives and Liberal Democrats (Lib-Dems).<sup>39</sup> The prospect of a “Cadbury Law” was discussed, with the Lib-Dem election manifesto in that year promising to “restore a public interest test so that a broader range of factors than just competition can be considered by regulators when takeovers are proposed”.<sup>40</sup> There was also some pressure within the Labour party for such a change, but it was opposed by

33 OFT, *Personal Current Accounts in the UK: An OFT market study* (London: OFT July 2008).

34 CC, *Lloyds TSB Group plc and Abbey National plc: A report on the proposed merger* (London: CC July 2001).

35 R Whish, *Competition Law* (Oxford: OUP 2009), pp. 814–15.

36 G Tichy, “What do we know about success and failure of mergers?” (2001) 1 *Journal of Industry, Competition and Trade* 347.

37 See comments by R H Lynne Jones MP, HC Debs, 26 January 2010, vol. 504, 30, from col. 783; House of Commons Briefing Paper, *Takeovers*, n. 17 above.

38 “Kraft confirms factory closure with loss of 400 jobs”, *The Times*, 9 February 2010.

39 See, for example, comments by Vince Cable on “The Today Programme”, BBC Radio 4, 10 February 2010.

40 Lib-Dem Manifesto 2010, p. 26.

the same Labour Business Secretary who had brokered the Lloyds/HBOS merger, Lord Mandelson. He said, “a political test for policing foreign ownership runs the risk of becoming protectionist and protectionism is not in our interests”.<sup>41</sup> The Labour Party manifesto instead proposed extending “the public interest test so that it is applied to potential takeovers of infrastructure and utility companies”.<sup>42</sup> No such change was promised by the Conservatives, but the Coalition government did indicate it would “review the range of factors that can be considered by regulators when takeovers are proposed”.<sup>43</sup>

### Are broader public interest considerations desirable in UK merger control?

As the public interest consideration “the stability of the UK financial system” had not been envisaged by Parliament, there is a question of whether the Lloyds/HBOS merger signals the need for a broader public interest assessment of mergers. In particular, would there be benefits from a formalised system in which the competition authority conducts both a competition and public interest assessment of every merger, with the final decision made by the Secretary of State? Such a system could include guidelines setting out criteria for public interest assessments. This might be more appropriate than the kind of intervention seen in the case of Lloyds/HBOS, in which the recommendations of the OFT were simply over-ruled on a basis which was the Business Secretary’s own creation, albeit with the hurried approval of Parliament.

It is worth looking at each of the justifications for public interest interventions individually. This section will consider whether the justification for allowing the Lloyds/HBOS merger, despite the competition concerns raised by the OFT, could apply to other industries. It will also ask whether the other concerns raised in the previous section would be addressed effectively by broader public interest interventions in merger control.

#### LLOYDS/HBOS AND THE STABILITY OF FINANCIAL MARKETS

The banking sector holds a set of unique characteristics which made it essential for governments to intervene in the financial crisis of 2007–2008.<sup>44</sup> The crisis came about because too much was lent on the basis of a low (and artificially inflated) capital base. When the market corrected itself, borrowers began defaulting on their loans. It quickly became clear that much of the debt was “toxic”, meaning that it was not backed by adequate capital. To make things worse, the bundling and exchange of debt between financial institutions made it hard to identify the toxic debt and accurately to determine each institution’s liabilities. Bankruptcy became an inevitable consequence. The situation came about through a combination of reckless behaviour by the banks and poor regulatory oversight and adverse incentives created by governments.<sup>45</sup> The question, therefore, is why reckless banks were not simply allowed to go bankrupt. Why did governments seek to protect, not only the savings of individual taxpayers, but also the banks themselves?

Confidence is central to banking and without it failure can become a self-fulfilling prophecy. This is because customers can withdraw their money at short notice but banks do not have the liquidity to pay out all, or even, most of their customers in one go. This is because they lend the money to businesses and other customers. The effect of a loss of confidence was demonstrated by the Northern Rock crisis in September 2007. Thousands

41 Lord Mandelson, Mansion House Speech, 1 March 2010.

42 Labour Party Manifesto 2010, pp. 1–7.

43 HM Government, *The Coalition: Our programme for government* (London: HM Government May 2010), p. 10; House of Commons Briefing Paper, *Takeovers*, n. 17 above.

44 B Lyons, “Competition policy, bailouts and the economic crisis” (2009) 5 *Competition Policy International* 25.

45 V V Acharya and M Richardson, “Causes of the financial crisis” (2009) 21 *Critical Review* 195.

of its customers queued to withdraw their money amid rumours the bank was about to fold. This continued despite the government guaranteeing retail depositors' money.<sup>46</sup> There are very few industries which are so sensitive to confidence.<sup>47</sup>

The availability of credit is of central importance to businesses throughout the economy. When banks restrict lending in order to rebuild their own reserves, there arises a danger that perfectly healthy profitable businesses will become bankrupt because they are unable to borrow in order to cover short-term costs. This is because of the fluctuations businesses face in their revenues and payments. A further unusual characteristic of the banking industry is that institutions will lend money to each other on an informal basis to cover their immediate debts. So a bank which has accepted more deposits than loans on a particular day will lend money to a bank in the reverse situation, in the form of an interbank loan. The banking industry is able to react well to the failure of small banks.<sup>48</sup> However, when the US bank Lehman Brothers, a major bank, collapsed in September 2008, other banks in the industry stopped lending to each other, unsure of which would be next to fold. In the UK, it was feared that the failure of HBOS, the most vulnerable of the UK banks, would have a similar effect on the UK banking sector.<sup>49</sup>

Reduced credit has a strong negative effect on the economy. Bailouts and nationalisation were the only way governments could restore a level of confidence in the banking industry which could once again facilitate lending. Thus, the Banking (Special Provisions) Act 2008 allowed the Treasury to nationalise failing banks or to direct their transfer to a third party. In the short term, governments tried to compensate for the shortage in credit by slashing interest rates, increasing spending and implementing short-term cuts in taxation.

No other sector of the economy can claim the same justification. When a major bank is allowed to fold, the banking sector stops lending and the wider economy risks coming to a halt. In regular industries, bankruptcy has very different consequences. Liquidators reallocate the bankrupt firm's capital and employ it elsewhere in the economy. Competitors move in to supply the bankrupt firm's customers. Bankruptcy is the normal way in which an industry sheds excess capacity or in which an inefficient firm leaves the sector. The treatment of the banking sector should not be extended, during times of crisis, to the wider economy. Indeed, there are empirical studies of the US and Japan which suggest that concentrations of market power during an economic crisis can be extremely damaging. The US National Industry Recovery Act 1933, which effectively legalised cartels in the wake of the Great Depression, and similar measures taken in Japan during the 1990s, are shown to have delayed economic recovery rather than promoting stability.<sup>50</sup>

So, the justification for allowing Lloyds/HBOS to merge on public interest grounds is peculiar to the banking sector. Indeed, some have subsequently argued that the merger failed even in its stated aim of achieving stability. Sir John Vickers, former chief of the OFT, argued that forcing the merger through on public interest grounds was a mistake

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46 Lyons, "Competition policy", n. 44 above; P Marsden and I Kokkoris, "The role of competition and state aid policy in financial and monetary law" (2010) 13 *Journal of International Economic Law* 875.

47 Lyons, "Competition policy", n. 44 above.

48 For example, A Akhigbe and J Madura, "Why do contagion effects vary among bank failures?" (2001) 25 *Journal of Banking & Finance* 657.

49 M Reynolds, S Macrory and M Chowdhury, "EU competition policy in the financial crisis: extraordinary measures" (2011) 33 *Fordham International Law Journal* 1670, 1718.

50 H L Cole and L E Ohanian, "New Deal policies and the persistence of the Great Depression: a general equilibrium analysis" (2004) 112 *Journal of Political Economy* 779; M E Porter and M Sakakibara, "Competition in Japan" (2004) 18 *Journal of Economic Perspectives* 27.

because it only restored confidence to the banking sector for a short period of time.<sup>51</sup> In November 2009, the European Commission approved a state recapitalisation of £17bn for the newly formed Lloyds Banking Group. In return for approving this state aid, Lloyds was required to divest 600 branches to create a new bank with a 4.6 per cent share of the personal current account market.<sup>52</sup> Sir John later became the chair of the Independent Commission on Banking. In November 2010, he said that the merger had seriously damaged competition and that HBOS should instead have been nationalised.<sup>53</sup> The Independent Commission on Banking's interim report notes that:

Although the acquisition by Lloyds TSB gave temporary respite to HBOS, it jeopardised Lloyds TSB. Large sums of public money had to be injected into the merged entity, which was renamed LBG, with the result that the Government now owns 41% of the group.<sup>54</sup>

The merger led to the loss of £2bn in share value for Lloyds, a loss that caused a small group of investors to launch legal action in March 2011, arguing that the Business Secretary deliberately withheld evidence that would have prevented the deal from going ahead.<sup>55</sup>

#### KRAFT/CADBURY AND OTHER CONCERNS

Despite criticisms, foreign acquisitions have brought a number of benefits to the UK. As well as encouraging foreign investment – most notably in the UK car industry – the opening of UK markets has transformed systems of management within firms. In stark contrast to the dark days of British Leyland, UK companies are now largely well run, albeit with widespread foreign ownership.<sup>56</sup> When foreign acquisitions are damaging, as is alleged to be the case with Cadbury, it might be more desirable to protect firms through better corporate governance, rather than allowing governments to intervene as they see fit on public interest grounds.

A number of commentators argued that Kraft's acquisition of Cadbury had been driven by investors with only short-term interests in the company's future.<sup>57</sup> These were misaligned with the longer-term interests of the firm, the main challenge being to enhance the power of long-term stakeholders to block damaging acquisitions. In a speech following the takeover, the then Business Secretary Lord Mandelson admitted:

In the case of Cadbury and Kraft, it is hard to ignore the fact that the fate of a company with a long history and many tens of thousands of employees was decided by people who had not owned the company a few weeks earlier, and probably had no intention of owning it a few weeks later.<sup>58</sup>

51 J Vickers, "The financial crisis and competition policy: some economics" (2008) 1 (December) *Global Competition Policy*.

52 European Commission, "State aid: Commission approves restructuring plan of Lloyds Banking Group", 18 November 2009.

53 "Sir John Vickers calls Lloyds takeover of HBOS a mistake", *The Guardian*, 26 November 2010.

54 Independent Commission on Banking, *Interim Report: Consultation on reform options* (London: Independent Commission on Banking April 2011), para. 5.34.

55 "Lloyds investors sue over HBOS merger", *Daily Mail*, 27 March 2011. At time of writing these cases were at a very preliminary stage.

56 See, for example, R Harris and C Robinson, "Foreign ownership and productivity in the United Kingdom: estimates for UK manufacturing using the ARD" (2003) 22 *Review of Industrial Organization* 207; S Girma et al., "Who benefits from foreign direct investment in the UK?" (2001) 48 *Scottish Journal of Political Economy* 119.

57 House of Commons, Business, Innovation and Skills (BIS) Committee, *Mergers Acquisitions and Takeovers: The takeover of Cadbury by Kraft*, *Ninth Report of Session 2009–2010* (Norwich: The Stationery Office 2010), HC Paper No 234 (Session 2009–2010), available at [www.publications.parliament.uk/pa/cm200910/cmselect/cmbis/234/23402.htm](http://www.publications.parliament.uk/pa/cm200910/cmselect/cmbis/234/23402.htm). paras 56–60.

58 Lord Mandelson, Mansion House Speech, 1 March 2010.

Suggestions of how to address this problem included:<sup>59</sup> raising the voting threshold needed to secure new ownership from a simple majority to two-thirds; lowering the requirement to disclose share ownership during a takeover bid from 1 to 0.5 per cent; giving the bidding company less time to tie up a deal; forcing bidders to disclose how they intend to finance the takeover; and requiring greater transparency on advisers' fees and incentives.<sup>60</sup> These proposals were not well received by city bosses and have not been adopted by the Coalition government.<sup>61</sup>

The short-termism which characterises many mergers is a valid criticism and is ultimately relevant to assessing a merger on competition grounds. Merger control is not about the finding of an infringement, but about predicting two futures: one with the merged firm operating in the market and one with the counter-factual. It is not always easy to determine whether a merger is likely to result in long-term gains or whether it is purely motivated by short-term profit. However, attempts to restrict parties' freedom to purchase businesses or dispose of their property as they see fit could, without clear justification, simply lead to uncertainty, which discourages both short-termist mergers and those which are beneficial to the economy.

Protecting employment is a social issue which is of great concern to many. However, the history of UK industrial policy is laden with examples of protecting inefficient and uncompetitive firms, only to prolong their painful demise.<sup>62</sup> Mergers can be an important way of increasing efficiency within an economy (for example, through economies of scale) or of consolidating excess capacity. Unemployment is sometimes a consequence of this. Efficiency should lead to lower prices and better quality, freeing up households' disposable income to create new demand and new markets. Similarly, capital operating inefficiently in one industry is better placed elsewhere. In this context, allowing governments to step in simply to protect jobs can ultimately be counter-productive. In the case of Cadbury, the firm had actually earmarked the Somerdale plant for closure before the takeover. Kraft had foolishly indicated that it would save the plant before properly investigating the circumstances surrounding its closure. Instead of intervening in mergers to save jobs, governments should instead focus on supporting those who have been made redundant and helping them to prepare for other jobs in the economy where they are needed. They can also encourage businesses to open operations in areas with high unemployment through regional development projects and tax incentives.

UK merger regulation actually allows for a "failing firm" defence under which a merger will not be blocked on SLC grounds where one of the firms would otherwise fail.<sup>63</sup> Such mergers might actually protect jobs, as compared to allowing the failing firm to fold entirely. It is interesting to note that, in its competition assessment, the OFT did not consider it likely that HBOS would fold and so did not consider the application of the failing-firm defence

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59 For a discussion, see B Clarke, "Directors' duties during an offer period – lessons from the Cadbury plc takeover", UCD Working Papers in Law, Criminology and Socio-Legal Studies, Research Paper No 44/2011 (unpublished manuscript).

60 BIS Committee, *Mergers Acquisitions and Takeovers*, n. 57 above, para. 64; "Mandelson calls for tougher takeover rules", BBC News, 1 March 2010; "Lord Mandelson calls for overhaul of takeover rules", *The Guardian*, 1 March 2010.

61 "Cadbury's Law is 'unworkable, costly and a threat to Britain', say City bosses", *Daily Telegraph*, 11 April 2010; HM Government, *The Coalition*, n. 43 above.

62 See, for example, D R Steel, "Government and industry in Britain" (1982) 12 *British Journal of Political Science* 449, and A Mair, "From British Leyland Motor Corporation to Rover Group: the search for a viable British model" in M Freyssenet et al. (eds), *One Best Way? Trajectories and industrial models of the world's automobile producers* (Oxford: OUP, 1988).

63 OFT, *Restatement of OFT's Position Regarding Acquisitions of Failing Firms* (London: OFT December 2008).

as appropriate in the Lloyds/HBOS case.<sup>64</sup> So far, the failing firm defence has succeeded in only a limited number of mergers, between firms operating in the transport, retail and manufacturing sectors.<sup>65</sup>

Finally, while it is true that mergers can create concentrations of wealth, the objectives of social policy and competition do not necessarily diverge here. As discussed in the introduction, merger control on competition grounds is about controlling market power to ensure it does not become too concentrated through monopolisation or cartelisation.<sup>66</sup> It seeks to promote efficiency and tends to be focused on the welfare of consumers, rather than companies. Merger laws in the US were actually strengthened at a time when concerns about concentration of wealth were particularly prominent.<sup>67</sup> In addition, abuse of dominance or monopolisation laws are an area of competition policy which specifically aims to curb large concentrations of power. Examples of this include the break-up of AT&T in the US and the European Commission's investigation of Microsoft.<sup>68</sup>

### Concluding remarks

Far from signalling the failure of an economics-based system of merger regulation, the Lloyds/HBOS merger highlights the importance of restricting political interventions on public interest grounds to exceptional circumstances in specific industries. Merger control on competition grounds encourages innovation and efficiency, bringing us new products for lower prices and less cost (in terms of resources), while preventing the exercise of excessive market power. The unforeseen circumstances which led to banks being bailed out and nationalised illustrate how difficult it is to foresee where public interest interventions will be needed. The need for protection was due to characteristics which were largely unique to the banking sector. Confidence is vital to the movement of credit and banks react to retractions in their capital base and the bankruptcy of other banks by tightening their lending. This risks starving the economy of vital credit with the consequence that even profitable commerce grinds to a halt because of an inability to cover short-term costs.

Indeed, there is reason to believe that Lloyds/HBOS failed to achieve the stated public interest interventions, having to be bailed out by the government after the merger. This has left a powerful bank which has significantly reduced competition. While competition policy tools do exist which can attempt to address this, for example, the European Commission requirement that 600 branches be sold in return for the bailout, *ex post* review and remedy can never be as effective as regulating a merger *ex ante*. This is because it is "extremely difficult to unscramble the proverbial egg".<sup>69</sup> There is thus a growing consensus that the merger should have been blocked on competition grounds and that HBOS should have been nationalised instead.

64 OFT, *Anticipated Acquisition*, n. 28 above, paras 59–60.

65 See OFT, *Restatement of OFT's Position*, n. 63 above; CC, *A Report on the Completed Acquisition of GV Instruments Limited by Thermo Electron Manufacturing Limited* (London: CC May 2007).

66 N Peterson, "Antitrust and the promotion of democracy and economic growth", Max Plank Institute for Research on Collective Goods (unpublished manuscript 2011) finds that antitrust laws have a positive effect on the level of GDP per capita and economic growth, although no significant positive effect on the level of democracy.

67 Whish, *Competition Law*, n. 35 above, p. 814, citing the example of *Brown Shoe Co. v United States* 370 US 294, 344 (1962).

68 S Coll, *The Deal of the Century: The breakup of AT&T* (New York: Simon & Schuster 1980); Commission Decision of 24 March 2004 relating to a proceeding under Article 82 of the EC Treaty (Case COMP/C-3/37.792 Microsoft).

69 Reynolds et al., "EU competition policy", n. 49 above, p. 1736.

The other concerns raised in support for wider public interest considerations are also unlikely to be well served by political interventions. Foreign acquisitions which are not in the interest of the UK firm are better dealt with through stronger corporate governance. These acquisitions are frequently driven by short-term stakeholders whose interests are misaligned with the long-term success of the firm. Intervening in merger control in order to protect jobs can be counter-productive. Merger control on competition grounds promotes efficiency within the economy and makes exceptions where one of the merging firms would otherwise become insolvent. Political interventions in this area are more likely to be driven by protectionism or populist concerns, rather than reasoned policy. Finally, merger control on competition grounds does not run counter to concerns about concentrations of wealth. Competition policy is about controlling large concentrations of market power and preventing what Polanyi viewed as the creature of competition, monopoly.

A return to broader political interventions on public interest grounds would risk creating inconsistency in merger regulation and uncertainty for firms. While such a regime might prevent some mergers viewed as damaging, it would also discourage mergers which benefit the economy and would make it less likely that foreign firms will invest in the UK. The unpredictable circumstances in which a public interest intervention might be perceived as being necessary – as in the Lloyds/HBOS merger – makes it impossible to provide a satisfactory definition of public interest. The competition authority could be asked to assess a merger on both competition grounds and public interest grounds, but it is the Secretary of State who must always make the final decision regarding public interest.

The ability to intervene in any case on public interest grounds raises a number of dangers, some of which characterised the UK's early merger control regime. First, the Secretary of State may respond to lobbying by special interest groups which represent only a small section of the electorate. Second, he or she may make decisions which are populist or motivated by political self-interest. In the case of foreign acquisitions, the Secretary of State might be far more willing to intervene where there is significant negative media coverage of the takeover. This means that interventions would occur in the case of household names such as Cadbury's, but not acquisitions involving less well-known companies. Interventions might also be more likely in the lead-up to a general election. Finally, the Secretary of State might be influenced by personal prejudice. In December 2010, the Business Secretary Vince Cable was stripped of his responsibility to decide whether News Corporation's acquisition of BSkyB should be blocked on public interest grounds, after telling an undercover journalist that he had "declared war" on News Corporation's owner, Rupert Murdoch.<sup>70</sup>

Despite the pressures of the current economic climate, the government has rightly declared its commitment to maintaining the independence of the competition authorities from political interference.<sup>71</sup> As part of their 2011 consultation on the UK competition regime, it was stated that: "Ministers will continue to take decisions only in the small minority of cases which raise defined, exceptional public interest issues."<sup>72</sup> The importance of this commitment was also stressed by Lord Mandelson, the former Business Secretary, who brokered the Lloyds/HBOS merger:

70 "Humiliated Vince Cable stripped of Sky role after 'war with Murdoch' gaffe", *The Guardian*, 21 December 2010.

71 For a broader discussion of how competition policy has reacted to the financial crisis see: P Lowe, "Competition policy and the global economic crisis" (2009) 5 *Competition Policy International*; D Gerard, "Managing the financial crisis in Europe: why competition law is part of the solution, not of the problem" (2008) 1 (December) *Global Competition Policy*.

72 BIS, *A Competition Regime for Growth: A consultation on options for reform* (London: BIS March 2011), para. 1.13.

a government's judgment and intervention . . . might give rise to capricious decision-making of one sort or another, depending on the ministers and their official advisers, and it can lead to a loss of transparency and a loss of predictability which at the moment makes the current UK regime open to investors from which, I just underline, we benefit a great deal.<sup>73</sup>

The current system works well in focusing on competition only, according to published guidelines which provide businesses with both transparency and predictability. Public interest interventions are restricted to a tiny number of identified industries where there is good reason to consider non-competition factors. If exceptional circumstances arise which give good reason for adding another industry to the list, it is right that the Secretary of State should need the approval of Parliament. Although the Enterprise Act essentially formalised what had been established practice for some years, it was very significant in preventing the exercise of political preferences in all but a very limited set of circumstances. As Peter Freeman, chair of the CC noted, the Lloyds/HBOS merger shows the UK system “in operation, not disarray”.<sup>74</sup>

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73 BIS Committee, *Mergers Acquisitions and Takeovers*, n. 57 above, para.73.

74 P Freeman, “Merging is such sweet sorrow”, speech to the British Institute of International and Comparative Law, “Mergers Conference”, 13 November 2008.