Competition Policy in Banking and Financial Services

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Introduction

The finance sector is an integral and important part of the economic system which has long been subjected to special regulatory attention – often involving limits on entry, ownership and competition. Within the financial system, banking has generally been given special attention, reflecting its central role as a repository of savings, source of loan finance, and provision of payments services.

Over time, however, the boundaries between banking and other parts of the financial sector have become blurred. Where permitted, banks have expanded into other areas such as investment banking, stock-broking, insurance and funds management, with activities ranging from provision of financial products to development and distribution of technology associated with delivery of financial products and back-office accounting and settlement functions. Similarly, non-bank institutions have encroached upon areas traditionally described as banking with alternative products and services which perform the same economic functions as those provided by banks.

Consequently, competition authorities need to take a broad functional perspective in dealing with the financial sector. There are many different ways in which the key economic functions of the financial sector can be performed, and focusing on a specific set of institutions (such as banks) may only serve to distort the way in which those functions are performed. Those economic functions are as follows:

- *a payments system for the exchange of goods and services* – involving Central Bank depository and settlement services, base money provision, bank provided payments and settlement arrangements, securities settlements services, credit card and EFT services, foreign exchange markets
- *a mechanism for the pooling of funds to undertake large-scale indivisible enterprise* – involving banks and depository institutions, institutional investors and mutual funds, stock exchanges, capital markets, investment banks, private equity firms .
- *a way to transfer economic resources through time and across geographic regions and industries* – involving savings, depository and other financial intermediaries, pension funds, foreign exchange markets, capital and money markets
- *a way to manage uncertainty and control risk* – involving insurance companies, financial intermediaries, forward markets, options and other derivatives markets.
- *price information which helps coordinate decentralized decision-making in various sectors of the economy* – involving money and capital markets, stock exchanges, foreign exchange markets.
- *a way to deal with the asymmetric information problems when one party to a financial transaction has information that the other party does not* – involving

ratings agencies, credit bureaus, banking relationships, collateral, security, and guarantee arrangements, auditing, disclosure requirements.

The message here is that an approach to competition policy focused on a specific set of institutions or financial products may simply serve to distort the nature of competition, as substitute services, products and providers spring up to avoid, or take advantage of, various features of regulation and policy.

More generally, financial institutions (unless constrained by regulation) may operate across a wide range of activities, performing a range of economic functions. Defining the "market" of interest for competition policy is not a simple matter in the case of financial services. A further complication arises from the ability of some financial services to be provided by suppliers located offshore, and outside the domain of the competition authority.

Special features of the finance sector important for competition policy

<u>Strategic role in the economy</u>

The finance sector determines the allocation of financial resources and is thus important in determining the sectoral, geographic, and demographic patterns of investment and saving. While a competitive financial sector should lead economic efficiency in this regard, there can be many imperfections which limit the degree of efficiency possible. For example, inability to discriminate between good and bad risk borrowers may lead to rationing of credit, rather than allocation purely on the basis of price. In many cases, governments have also been concerned about the ownership structure of the financial sector, and the possibility of excessive concentration of economic power.

<u>Managing orderly exit of failures and prudential regulation</u>

Effective competition involves both the (threat of) new entrants, and the exit of inefficient, uncompetitive, incumbents – the process described by the well known economist Joseph Schumpeter as "creative destruction". That creates complications in the finance sector, because most financial products involve promises for future payments of receipts, often involving customers who are not sufficiently financially sophisticated to correctly assess the risks associated with these products. One risk for competition policy is that prudential regulation may lead to excessive protection of existing institutions

<u>Financial stability</u>

Financial systems are susceptible to periodic episodes of systemic instability. Both financial institutions and financial markets provide a valuable economic service of providing liquidity – enabling longer term productive physical investments to be reconciled with short term savings preferences. Doing so involves risk taking by participants, particularly that liquidity problems may evolve into solvency problems – if asset fire-sales are required to generate liquidity. The international financial crisis of 2007-8 illustrates this risk clearly, and also demonstrates the risk for competition policy – that to preserve financial system stability, governments and regulators may feel compelled to intervene to support or bail-out incumbent institutions.

Economies of scale and scope

It is generally accepted that there exist economies of scale in banking (and other parts of the financial sector), such that average costs fall with increasing output, at least up to moderate size levels. Levels of concentration in banking (except in countries such as the USA where (now removed) restrictions on interstate banking and branching led to many small banks) are consistent with this. There is less solid evidence for the existence of economies of scope (lower costs from delivery of a range of products by one organization than when delivered separately by multiple organizations. Constantly changing technology for the manufacture, delivery, and back-office functions associated with financial products does, however, raise the question of the contemporary applicability of historical estimates of such economies. Nevertheless, competition policy is faced with the constraint that feasible competition in some parts of the financial sector is likely to involve a relatively small number of relatively large players.

International trade in financial services

Particularly with the development of electronic communications of the last twenty years, many financial products can be delivered from offshore – since there may be no need for physical contact between the parties involved. Indeed, many providers of some services, hedge funds for example, may be domiciled in countries with preferential tax arrangements, with only a marketing/representation function in the country where customers are located. The applicability of national laws to resolution of contractual difficulties and of national consumer protection arrangements in these cases is an issue which needs to be considered by competition authorities when considering the costs and benefits of encouraging/discouraging involvement of offshore providers.

Consumer information and switching costs

An important feature of financial markets is the existence of imperfect information. Many users of financial services have low levels of financial literacy and are not able to readily assess costs, returns, or levels of risk. Competition can involve exploitative behavior by unethical market participants, or may lead to marketing based on unwarranted claims about product characteristics and suitability. In these circumstances, competition authorities need to consider the appropriate licensing requirements for providing certain financial products, and the role of dispute resolution mechanisms and penalties for inappropriate behavior.

Another feature of financial markets is the role of switching costs. Current customers of a financial institution may face significant costs in switching their business to a competitor. These may involve exit fees, loss of any benefits of the established relationship, costs of establishing a relationship with a different institution, resource costs involved in switching accounts (providing identification, altering direct debits and credits etc). Consequently, there is scope for institutions to charge existing customers higher prices, and attempting to attract new customers by discounted offers. The nature of competition in a market with substantial switching costs needs to be recognized by competition authorities.

Network economies and information sharing

Some financial services, particularly payments services, have network characteristics, and require cooperation between participants for their effective delivery. Incumbents with market power may determine prices and charges which exploit that market power and cause inefficiency. Where co-provision of such services is a highly desirable in providing other financial products, exclusion from the network may impact upon effective competition in those other areas.

There may be social value in sharing of information – such as through credit bureaus where information on credit histories of potential borrowers is stored. Such cooperative behavior reduces the costs of information acquisition for lenders, but provides the bureau with a degree of market power with regard to such information. While the need to get information from lenders (to maintain the value of the database) as well as providing information limits the likelihood of monopolistic behavior towards existing lenders, the potential exists (if owned by incumbent lenders) for pricing which inhibits entry of new lenders.

How have attitudes to bank competition policy changed over time

For much of the twentieth century, many nations adopted a fairly common approach to banking sector competition policy. Entry into banking was relatively difficult, and in the case of foreign banks often impossible. There was substantial "economic regulation" of bank activities, involving constraints on activities, interest rates, portfolios, etc. Banks were often subject to lending directives. Those policies typically had two consequences. First, non-bank financial institutions emerged which operated outside the extant regulations. Second banks found ways to avoid the impact of those regulations.

That historical approach was generally based upon concerns about prudential regulation (although use of that term is a relatively modern phenomenon), consumer protection, and financial sector stability. But a desire of governments to influence the patterns of finance to meet national social and economic objectives often also played a role. In addition, some authors have pointed to the political power of the vested interests of incumbents in preventing the entry of competitors and maintaining restricted competition and excess profits.

Over recent decades, financial liberalization has become common, with the removal of many of those features of "economic regulation". Often however, that occurred without adequate attention being paid to the design of suitable arrangements for a competitive financial sector. Specifically, not enough attention was paid to issues of appropriate governance arrangements, market discipline, disclosure, consumer protection, legal arrangements, supervision, etc which are necessary for the effective working of a liberalized financial sector.

Consequently, following the problems which emerged in many deregulated financial systems, the emphasis of regulation has changed from

- "economic regulation"— such things as controls on prices, profits, entry/exit,

to a greater focus on

- "Health-safety-environment (HSE) regulation" – such things as prudential regulation, the development of corporate governance and bankruptcy systems, safeguards in securities markets
- "Information regulation" - requirements for specific types of information, often in a standardized format, that must be provided with the product or service.

For competition regulators, the nature of that "financial infrastructure" of HSE and information regulation needs to be considered in making decisions about economic regulation.

Underpinning the move towards more liberalized financial systems has been the continued emergence of research confirming the role of financial sector development in promoting economic growth. While there is relatively little empirical evidence on specific characteristics of financial sector development which are beneficial to economic growth, a causal link from financial sector development to economic growth is well established.

How is the market defined?

A major difficulty for the application of competition policy to financial services is that of defining a "market". Modern electronic communications and technology are rendering geographical definitions less relevant – as customers can deal with financial service provides located in distant locations for most services.

Focusing on institutionally defined groups such as banks or insurance companies is also hazardous, since these institutions operate across a range of products and services and face competition from alternative suppliers of such services.

Similarly, focusing on specific products or services runs into the problem that differently labeled or designed products can offer provide some or all of the economic functions or relevance.

More generally, financial institutions can be more or less vertically integrated. Thus for example, retail investors may obtain advice from a financial planner, who uses a particular accounting and software platform, executes transactions, invests in specific mutual funds which use a custodian firm and trustees – all of which stages (including the financial planning firm) involve products or services provided by subsidiaries of the same institution.

What is evidence on market concentration trends?

Most national banking systems are highly concentrated, and widespread industry consolidation over recent decades has seen a decline in the number of smaller banks but little increase in indicators of concentration. Of 105 countries for which data on bank concentration was available for 2005, 85 had three-firm concentration ratios above 50 per cent, 53 above 75 per cent, and 31 above 90 per cent. Technological and regulatory change suggest that ongoing consolidation will reduce the number of smaller banks, and that large multinational banks will play an increasing role in domestic banking markets.

Within many national banking markets there has been substantial consolidation, reflecting influences such as regulatory and technological change. There has been substantial merger activity among large banking groups (including cross-border expansion) raising the issue of the impact of increased concentration both at a global and national level. More foreign and mid-sized domestic competitors may reduce concerns about the effects of concentration on competition, but raise important policy issues for prudential policy and financial stability.

Table 1 demonstrates the growth in the size of the world's largest banks relative to world GDP. What is noticeable, however, is that there is substantial movement within this international league table.

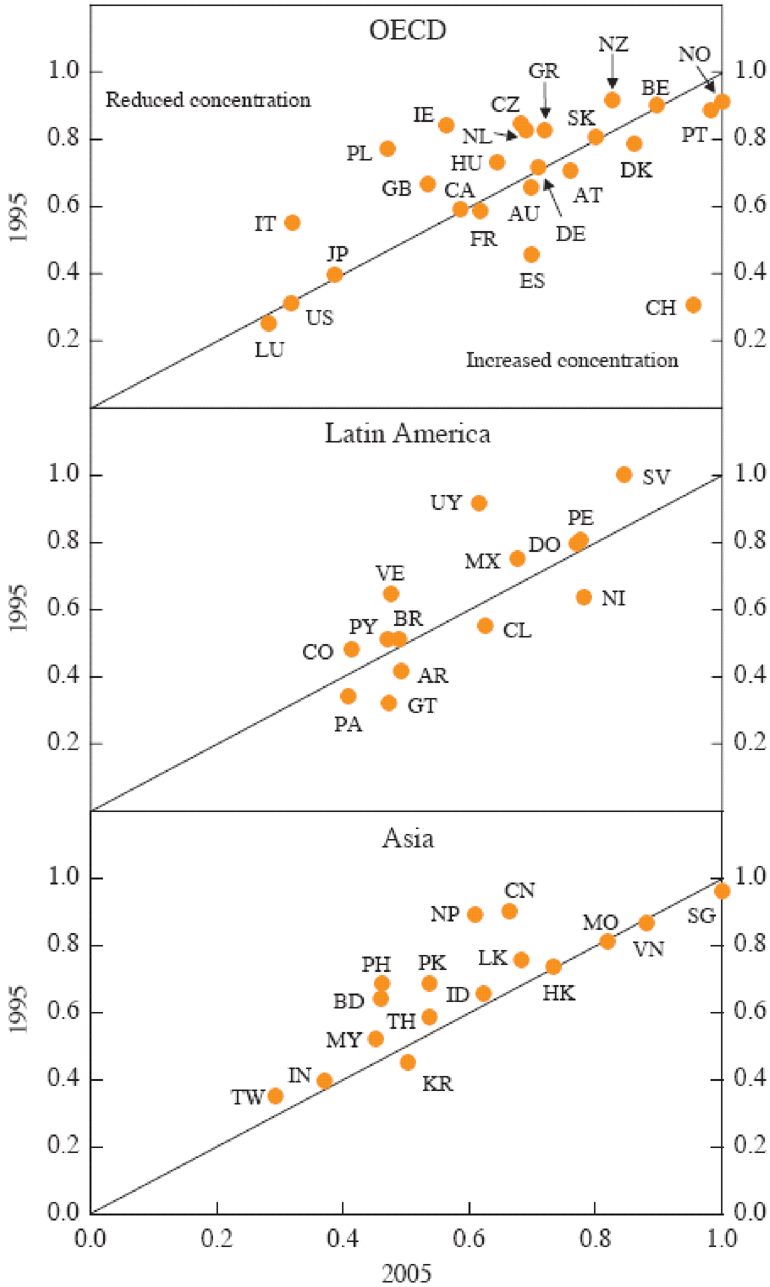
Table 1: World Largest Banks: Assets $US bill

	Bank	**2005**	**Bank**	**2004**	**Bank**	**1995**	**Bank**	**1985**
1	Barclays Bank	1,587	UBS	1,553	Deutsche Bank	503	Citicorp	167
2	Mitsubishi UFJ	1,585	Citigroup	1,484	Sanwa Bank	501	Dai-Ichi Kangyo	158
3	UBS	1,563	Mizuho	1,296	Sumitomo Bank	500	Fuji Bank	142
4	HSBC	1,499	HSBC	1,277	Dai-Ichi Kangyo	499	Sumitomo Bank	136
5	Citigroup	1,494	Credit Agricole	1,243	Fuji Bank	487	Mitsubishi Bank	133
6	BNP Paribas	1,484	BNP Paribas	1,234	Sakura Bank	478	Banque Nationale de Paris	123
7	Groupe Crédit Agricole	1,380	JP Morgan Chase	1,157	Mitsubishi Bank	475	Sanwa Bank	123
8	Royal Bank of Scotland Group	1,334	Deutsche Bank	1,144	Norinchukin Bank	430	Credit Agricole	123
9	Bank of America	1,294	Royal Bank of Scotland	1,119	Credit Agricole	386	BankAmerica	115
10	Mizuho	1,268	Bank of America	1,110	ICBC (China)	374	Credit Lyonnais	111
	Total	*16494*		*14621*		*6628*		*3316*
Largest bank's assets /G7 GDP		5.9%		6.0%		2.6%		2.1%
Top 10 banks' assets / G7 GDP		60.9%		56.2%		33.9%		41.3%
Top 10 banks' assets /world GDP		36.9%		35.3%		22.5%		25.7%

Sources: Bank assets: *The Economist* 5/20/06, *Euromoney* August 2006
World GDP - IMF World Economic Outlook Database, April 2007
http://www.imf.org/external/pubs/ft/weo/2007/01/data/index.aspx

Figure 1 shows changes in banking sector concentration between 1995 and 2005 in a range of countries. Despite many mergers and a declining number of small banks, the three firm concentration ratios do not suggest substantial increases in concentration.

Figure 1: Bank Concentration – Selected Countries
Share of assets of the three largest commercial banks



Turning to bank mergers, there has been relatively greater merger activity in the financial sector than in other industries. Second, the volume of banking sector merger activity has declined since its peak at the turn of the century, but there has been a much smaller decline in the aggregate value of mergers. There have been fewer smaller institutions available as merger partners, and a greater role for larger scale mergers, including an increase in cross-border mergers. As a broad generalization, the changing size distribution of banking firms in national markets is largely the result of mergers rather than "organic" growth, showing up as fewer small and more mid-sized banking firms, but not in concentration ratios.

One important feature of recent bank merger activity has been the importance of cross border acquisitions. For the 106 (out of 143) countries for which data was available in a recent World Bank survey (World Bank, 2007) there were 321 applications for foreign bank entry by acquisition over the five years to 2006. This compares to 592 applications for entry by establishing a branch or new subsidiary for the same set of countries.

There is little obvious evidence of any relationship between concentration and foreign penetration of domestic banking markets. The table below presents data for 98 countries, grouped by foreign bank market share. For a significant number of countries, foreign banks have a large market share, but there is no obvious correlation between concentration ratios and foreign bank share. There does, however, appear to be a negative relationship between Government-owned bank market share and foreign bank market share (except for those countries where foreign banks have zero presence).

Foreign Bank Share and Concentration[(a)]

Foreign Share	*Number of Countries*	*Average foreign bank share*	*Average government bank share*	*Average 5 firm concentration ratio*
Equals 0	4	0%	4%	78%
0-10%	18	7%	25%	67%
10-30%	24	20%	20%	75%
30-50%	17	42%	13%	71%
50-70%	14	59%	13%	79%
70-100%	21	92%	2%	73%

(a) Market shares and concentration measured in terms of commercial bank assets
Source: World Bank (2007)

Assessing the extent and effects of competition

Measures of concentration are sometimes used as simple indicators of competition, but are unlikely to be reliable. Competition between a small number of large players can be fierce, while problems defining the scope of the market also create problems.

Sometimes simple measures such as interest rate margins are used – with a lower interest rate margin interpreted as suggesting greater competition. However, these are distorted by varying reliance upon fee income by banks. Similarly profit measures need to be adjusted for risk before they can convey valuable information regarding the existence or otherwise of excess returns – and this is not a simple task.

One technical measure which has become fashionable in recent times is the H-statistic. This is a measure of competition based on the estimated responsiveness of firm revenue to changes in factor input prices. (It is calculated by summing the estimated elasticities of revenue to factor prices, with a value of 1 indicating perfect competition, a value of zero (or less) indicating monopoly, and intermediate values indicating the degree of monopolistic competition).

For Australia, for example, published estimates of the H-statistic lie in the range of 0.63 to 0.80, which implies that the market is relatively competitive, despite the high degree of concentration. While these results are suggestive of a situation in which high concentration does not impede competition in domestic banking markets, data limitations mean that the results should perhaps be treated with some caution. Consolidated data is used, thus incorporating offshore and non-traditional banking activities of the banks. Proxies for factor input costs, such as the use of labor expenses / total assets to measure unit wage costs, may be poor measures in a time of significant changes in bank service delivery methods. The robustness of the calculated H-statistic which is based on estimation techniques which assume cost minimization may also be questionable, when existing research indicates quite low levels of average cost efficiency in Australian banking (relative to an estimated best-practice frontier).
Another concern is that the H-statistic was developed for single product market industries, but in the case of banking is applied to multi-product firms.

Who is involved in competition policy for financial services

Because of the nature of the financial services sector, numerous agencies are likely to be involved in decisions on entry, exit and mergers, together with assessing whether market practices involve anti-competitive behavior. As well as the competition authority, other agencies who may be expected to play a role include: prudential regulators, central banks, treasuries/ministries of finance, securities regulators, foreign investment review boards, and politicians. Determining the appropriate roles and responsibilities is an important issue.

What types of policies are in place?

Australia provides a useful case study of the types of policy instruments in place which are relevant to competition policy. They include:

- Minimum entry requirements (capital, governance etc) – some minimum level of capital is required, and the directors and senior management are required to meet appropriate “fit and proper” standards.
- Restrictions on international entry – in Australia, foreign banks are effectively precluded from entering the retail market as branches of the foreign parent, but can do so by establishing a separately capitalized subsidiary.
- Merger restrictions – the “Four Pillars” policy, prevents mergers between the four largest banks.
- Bank Shareholdings Act – there is a maximum 15 per cent shareholding allowed in a bank.