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ANTITRUST ENFORCEMENT IN REGULATED SECTORS
SUBGROUP 1

AN INCREASING ROLE FOR COMPETITION IN THE REGULATION OF BANKS

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This Report has been drafted by Darryl Biggar (Australian Competition and Consumer Commission, ACCC) and Alberto Heimler (Italian Antitrust Authority and co-chair of subgroup 1 of the AERS Working Group). The competition authorities of Brazil, Hungary, Indonesia, Mexico, South Africa and South Korea provided very useful inputs. Comments and suggestions were received from ICN members and from the following individuals: Ginevra Bruzzone (Assonime), Frédéric Jenny (Professor of economics at ESSEC and co-chair of subgroup 1 of the AERS Working Group), Paul Wachtel (New York University) and, in particular, Massimo Marchesi. The ICN AERS Working Group, subgroup 1, thanks very much those that contributed.

I. INTRODUCTION

1. Banking regulation originates from microeconomic concerns over the ability of bank creditors (depositors) to monitor the risks originating on the lending side and from micro and macroeconomic concerns over the stability of the banking system in the case of a bank crisis. In addition to statutory and administrative regulatory provisions, the banking sector has been subject to widespread "informal" regulation, i.e., the government's use of its discretion, outside formalized legislation, to influence banking sector outcomes (for example, to bail out insolvent banks, decide on bank mergers or maintain significant State ownership).

2. Banks in one form or another have been subject to the following non exhaustive list of regulatory provisions: 1) restrictions on branching and new entry; 2) restrictions on pricing (interest rate controls and other controls on prices or fees); 3) line-of-business restrictions and regulations on ownership linkages among financial institutions; 4) restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements and/or not to hold other securities, including requirements not to hold the control of non financial companies); 5) compulsory deposit insurance (or informal deposit insurance, in the form of an expectation that government will bail out depositors in the event of insolvency); 6) capital-adequacy requirements; 7) reserve requirements (requirements to hold a certain quantity of the liabilities of the central bank); 8) requirements to direct credit to favored sectors or enterprises (in the form of either formal rules, or informal government pressure); 9) expectations that, in the event of difficulty, banks will receive assistance in the form of "lender of last resort"; 10) special rules concerning mergers (not always subject to a competition standard) or failing banks (e.g., liquidation, winding up, insolvency, composition or analogous proceedings in the banking sector); 11) other rules affecting cooperation within the banking sector (e.g., with respect to payment systems).

3. In recent years regulation in banking has become less pervasive and has shifted from structural regulation to other more market oriented forms of regulation. As a consequence competition has come to play a very important role in the allocation of credit and in the improvement of financial services. The capital requirements framework created in the context of the Basel committee paved the way to the development of stronger competition in banking. It is unquestionable that all over the world banks now face greater competition both from new entrants in the banking sector and from other financial companies.

4. Competition authorities have not been much involved in the process of liberalization of banking. Moreover, in several countries the enforcement of antitrust rules until very recently has not been applicable to banking because of sectoral exceptions.

5. In this light, the purpose of this report is:

- to assist policy makers and enforcement authorities (in their competition advocacy function) in their efforts to promote competition oriented regulatory reform in banking;
- to assist policy-makers and enforcement authorities (in their competition advocacy function) in promoting an environment where competition law is fully applicable to banking and where there is an appropriate institutional setting to that end; and

- to assist competition enforcement authorities in the enforcement of competition law in this sector, with a special emphasis on merger control.

6. The structure of the report is as follows. First, it briefly reviews the recent history of banking regulation (section II). Second, it discusses (under the perspective of competition authorities) the market failures banking are exposed to, their macroeconomic consequences (section III), and the most common regulatory instruments introduced to address them (section IV). Then, the report examines the impact of recent liberalizations on market power in banking (section V). A brief description of banking issues in developing countries follows (section VI). Finally, the report turns to competition issues, addressing first the application and scope of competition law (section VII) and then examining issues of enforcement of competition law, with a particular emphasis on merger control (section VIII). The final section concludes with a number of recommendations.

II THE RECENT HISTORY OF REGULATORY REFORM IN BANKING

7. In the early 70s financial systems "were characterized by important restrictions on market forces which included controls on the prices or quantities of business conducted by financial institutions, restrictions on market access, and, in some cases, controls on the allocation of finance amongst alternative borrowers. These regulatory restrictions served a number of social and economic policy objectives of governments. Direct controls were used in many countries to allocate finance to preferred industries during the post-war period; restrictions on market access and competition were partly motivated by a concern for financial stability; protection of small savers with limited financial knowledge was an important objective of controls on banks; and controls on banks were frequently used as instruments of macroeconomic management".[1]

8. Since the mid 70s there has been a significant process of regulatory reform in the financial systems of most countries. This process involved a shift towards more market-oriented forms of regulation and involved partial or complete liberalization of the following:

- *interest rate controls*

  Until the early 1970s controls on borrowing and lending rates were pervasive in most countries. These controls typically held both rates below their free-market levels. As a result, banks rationed credit to privileged borrowers. By 1990 only a handful of countries retained these controls.

- *quantitative investment restrictions on financial institutions*

  Investment restrictions on banks took a variety of forms, including requirements to hold government securities, credit allocation rules, required lending to favored institutions and controls on the total volume of credit expansion. Compulsory holdings of government securities, as well as having a prudential justification, also acted as a disguised form of taxation in that it allowed governments to keep security yields artificially low. With some exceptions these controls were largely eliminated by the early 1990s.

[1] Edey and Hviding (1995), p4.

- *line-of-business restrictions and regulations on ownership linkages among financial institutions*

  Although important line-of-business restrictions still remain in place in many countries, the role of these restrictions has been significantly eroded or, in some cases, entirely eliminated. For example, the separation of savings-and-loans and commercial banks has been largely eliminated in many countries, as has the distinction between long-term and short-term credit institutions in Italy and the legal separation of various types of credit suppliers in Japan. Bank branching restrictions were phased out in a number of European countries by the early 1990s. In the US "breaking down the barriers imposed by the (1933) Glass-Steagall Act the Gramm-Leach-Bliley Financial Service Modernization Act of 1999 permits banks, securities firms, and insurance companies to affiliate within a new structure – the financial holding company"[2].

- *restrictions on the entry of foreign financial institutions*

  There has been significant liberalization of cross-border access to foreign banks. In particular, there are now in place a number of international agreements on trade in banking services, including GATS, NAFTA and the EC. In particular, in the European Union, the second banking directive (89/646/EEC) forbade the obligation for banks established in one Member State to seek authorization from other Member States when they intended to establish a branch in their territory. In many countries however the entry of foreign banks is still made more difficult than that of domestic ones.

- *controls on international capital movements and foreign exchange transactions*

  Liberalization of controls on capital movements is now virtually complete in OECD countries and in many developing countries as well[3]. Some controls remain on long-term capital movements, particularly with respect to foreign ownership of real estate and foreign direct investment. There also remain important restrictions on international portfolio diversification by pension and insurance funds.

The origins of regulatory reform

9. Regulatory reform was driven by a number of inter-related factors, including:

- the diminishing effectiveness of traditional controls due to financial innovation (including the difficulty of isolating domestic markets) and rapid technological development;

- the development of various types of regulatory avoidance (such as the development of offshore financial centers and off-balance-sheet methods of financing);

- competition between international financial centers;

[2] See Crockett *et al.* (2003)
[3] The beneficial effects of capital movements liberalization for developing countries are still controversial.

- competition with non banks for many services (consumer credit; small business loans; mortgages; etc.);
- competition between financial institutions under different regulatory environments; and, finally,
- multilateral agreements liberalizing cross-border banking activities.

Benefits from regulatory reform

10. Regulatory reform has raised efficiency and lowered costs in the financial services sector:
    - First, the removal of regulatory restrictions gave financial firms more freedom to adopt the most efficient practices and to develop new products and services.
    - Second, regulatory reform increased the role of competition, which in turn spurred reductions in margins in financial services and raised efficiency by forcing the exit or consolidation of relatively inefficient firms and by encouraging innovation[4].

11. Regulatory reform furthermore contributed to:
    - declining relative prices for financial services and productivity growth well in excess of that for the economy as a whole[5];
    - considerable improvements in the quality, variety and access to new financial instruments and services;
    - improved world allocation of resources due to the removal of the barriers to international capital flows;
    - significant improvements in growth performance in a number of developing countries[6].

Regulation has been maintained but has progressively been reformed

12. The progressive liberalization from structural regulatory restrictions such as the ones mentioned above has not led to the deregulation of banking activity, but to the adoption of new instruments of prudential regulation more compatible with competition in the banking sector. The first and most known milestone of this new trend in regulation is the Basel Accord of July 1988 which required the major international banks in a group of 12 countries to attain an 8% ratio between capital and risk-weighted assets from the beginning of 1992.

13. Subsequently, the increasing range and sophistication of financial instruments made the limitations of the probably too simple design of the 1988 capital-adequacy framework become apparent. Already in 1997 the Basel Committee on Banking Supervision, seeking to further enhance banking supervision in both G10 countries and a number of emerging economies, released a set of "Core Principles" which set out minimum requirements for banking

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[4] OECD (1997[a]), p83.

[5] "Estimates indicate that overall financial service sector productivity increased at an annual rate of nearly 4 per cent in the US over 1980-93, nearly three times the rate of the economy as a whole". OECD (1997[a]), p. 84.

[6] See among others and more recently Claessens amd Laeven (2005).

supervision. The document also sets out an extensive list of recommended powers of banking supervisory authorities.

14. Finally, in June 2004 the Basel Committee on Banking Supervision issued a revised framework (Basel 2) for measuring capital adequacy and for identifying new minimum capital requirements for banks (Pillar 1). The new framework encourages banks to develop their own in-house risk-management systems to compute in a much more precise and sophisticated way their minimum capital requirements , with supervisory oversight present in the endorsement of the adequacy of the system. The proposals of the Committee, expected to be progressively implemented from the end of 2006, also introduce two additional pillars for banking regulation that are expected to become more and more important in complementing capital adequacy requirements. Pillar 2 introduces a continuous dialogue between banks and their supervisor in order to follow and accommodate changing and evolving business practices. Pillar 3 calls for improving the flow of information to the public on banks financial conditions, so that market discipline can exercise a greater role in reducing excessive risks in banking activities.

III. BANKING REGULATION: THE RISK OF BANK RUNS AND OF MORAL HAZARD IN BANKING AND THEIR EFFECTS ON THE ECONOMY

15. It is widely accepted that in the absence of market failures, open and competitive markets yield strong incentives to efficiently meet the demands of consumers and to adapt to changing demands and technology over time. With very few exceptions, in the absence of a market failure there is no economic justification for regulation.

16. The most important rationale for regulation in banking is to address concerns over the safety and stability of financial institutions, the financial sector as a whole, or the payments system. The description and the evaluation that follows necessarily reflect the views of competition authorities. With only one exception, no bank regulator has reviewed this Report which, therefore, does not necessarily reflect the positions and the opinions of bank regulators.

The risk of bank runs

17. All banks operate in conditions of fractional liquidity reserve. The great majority of banks liabilities are very liquid deposits redeemable on demand. The great majority of their assets are instead much more illiquid loans. This situation leads to the problem that if all depositors demanded their deposits back at the same time, any bank (even if perfectly solvent) would face serious problems in meeting its obligations *vis à vis* its depositors. A single bank might obtain refinancing on the financial market but the problem would severely persist in cases of low liquidity on the market or if the issue concerned a big portion of the banking sector.

18. It is well known in the literature that whenever depositors start fearing the insolvency of their bank, their first most common reaction is to go and withdraw their deposits creating serious problems to the banks. Such behavior is normally referred to as a bank runI[7].

[7] There are two alternative theories that have been proposed for explaining bank runs. Some authors, for example Diamond and Dybvig (1983), consider bank runs as a sunspot phenomenon, unrelated to any underlying economic variables. Others, for example Bryant (1980), suggest that bank runs originate from some negative information (either right or wrong) depositors have on the quality of the assets of their bank.

The risk of excessive risk taking (moral hazard) in banking

19. Banks grant loans normally financed by the deposits they received. This is by itself a powerful incentive for banks to grant credit in a not sufficiently prudent way and to take in too much risk. In fact it is well known in the literature that with debt financing, while the risk of failure of the financed investment is mostly carried out by the bank depositors, in the case of success profits accrue mostly to the bank[8]..A good example of this deviating behavior is the Asian financial crisis of 1997 that is mentioned further below. In general, however, this incentive is somehow mitigated by the possibility that the market, both via depositors and other banks, could monitor the risks assumed by the bank's management.

20. The main purpose of regulation is to avoid the highly negative consequences for the economy of widespread bank failures. There are two main strands of arguments for banking regulation. – The first focuses on the systemic dangers of bank failures, while the second on the need for security and stability in the payments system.

Systemic dangers of a bank failure

21. The main argument for bank regulation focuses on the possibility of systemic or system-wide consequences of a bank failure. i.e., the possibility that the failure of one institution could lead to the failure of others. This argument is summarized by Feldstein as follows:

> "The banking system as a whole is a 'public good' that benefits the nation over and above the profits that is earns for the banks' shareholders. Systemic risks to the banking system are risks for the nation as a whole. Although the management and shareholders of individual institutions are, of course, eager to protect the solvency of their own institutions, they do not adequately take into account the adverse effects to the nation of systemic failure. Banks left to themselves will accept more risk than is optimal from a systemic point of view. That is the basic case for government regulation of banking activity and the establishment of capital requirements".[9]

22. It is possible to distinguish two mechanisms by which the failure of one bank could lead to the failure of other banks or other non-bank firms:

(a) the failure of one bank leading to a decline in the value of the assets sufficient to induce the failure of another bank ("consequent failure") and

(b) the failure of one bank leading to the failure of another fully solvent bank, through some contagion mechanism ("contagion failure")

Consequent failure

23. The failure of a bank, like the failure of any other firm in the economy, may, of course, lead to the failure of other firms exposed towards the failing bank. The loss of value associated with the failure leads to a reduction in the value of assets held by its stakeholders. If this loss in value is sufficiently large and/or the stakeholders themselves are near enough to failure, the stakeholders may, in turn, fail.[10]

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[8] See Dewatripont and Tirole (1994).
[9] Feldstein (1991),
[10] See Kaufman (1996) , p. 25.

29. Although there are, in general, strong incentives to diversify, in the case of a large firm there may be a number of other firms (such as its suppliers) who are unable to diversify adequately and whose survival is threatened by the large firm's insolvency. However, in general, banks *are* able to diversify. They are not constrained to retain their assets with a bank that is in difficulty. The decision to invest in a distressed bank is a risk-management decision like all other investment decisions. Provided the investing bank is aware of the risk it is taking, there is no externality. The externality can however originate from the fact that full information on potential risk is not immediately, correctly and easily achievable.

Contagion failure

24. A majority of authors argue that there is an important asymmetry between the information available to banks and the information available to depositors and other outside investors. "Banks can utilize economies of scale and specialization to reduce the transactions costs of determining the probability that a borrower will not repay a loan as promised, to monitor the borrower's performance and circumstances, and to take effective actions to reduce the probability and cost of defaults. Thus banks have information about the value of loans that depositors and other outside investors do not have.".[11]

25. In the most extreme case of this information asymmetry, depositors cannot distinguish solvent from insolvent banks. As a result, news that one institution is failing can be interpreted as information that other institutions are in difficulty. "Depositors rush to make withdrawals from solvent as well as insolvent banks since they cannot distinguish between them".[12] It is possible that the failure of one institution may lead to a generic flight of funds from all institutions. The available evidence does not always suggests that this has happened.

Dangers to the soundness of the payments system

26. We turn now to the arguments relating to the stability and soundness of the payments system. These arguments are summarised in the following comment:

> "An efficient payments system, in which transferability of claims is effected in full and on time, is a prerequisite for an efficient macroeconomy. Disruptions in the payments system carry the risk of resulting in significant disruptions in aggregate economic activity. To some observers, instability in the payments system is more threatening than instability in deposits. This fear appears to reflect the larger dollar volume of daily payments, the speedy movement of the funds and the unfamiliarity of the clearing process". [13]

27. Until recently the standard form of settlement between banks was end-of-day net settlement. Banks would accumulate their obligations to other banks throughout the day in order to settle the smaller net obligations at the end of the trading day. The risk of this form of settlement is that it usually requires participants to grant unsecured and unlimited credit to other participants during the day until final settlement occurs. Credit extended to a single party can sometimes exceed a bank's entire capital. Like other forms of credit, the potential exists for default. If the expected payment to the bank extending credit does not materialize in full and on

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[11] Benston and Kaufman (1995), p216.
[12] Mishkin (1991),.
[13] Benston and Kaufman (1995), p37.

a timely basis, previous payments may need to be reversed or unwound. "This may be complex and time-consuming and cause 'gridlock' in the payments system that interrupts the smooth flow of trade. Moreover, if the losses to the paying bank from customer defaults were large enough to drive it into insolvency, the receiving banks would experience losses, which might be sufficient to drive them to insolvency if these losses exceed their capital".[14]

28. An obvious candidate solution to this kind of problems is to prevent the intraday build-up of credit exposures by insisting that inter-bank payments occur at the same time as the exchange of the corresponding assets. This is known as "real-time" settlement. Such "real-time" trading systems have already been implemented in some countries.

29. In the case of international transactions, the problem of intra-day exposure is however somewhat more complicated. The problem arises because of the different timing for daily settlement in each national bank system. For example, in a NZ Dollar/US Dollar foreign exchange transaction, the NZ$ leg must be settled even before the US system for settling the US$ leg is open for the day. This gives rise to what is known as "Herstatt risk", named after the failure of a small German bank, Bankhaus Herstatt in 1974. This bank was active in the foreign exchange markets. It defaulted after receiving deutschmarks from international banks but before the matching US dollar leg was processed later in the day. This left its counterparties exposed to the full value of the Deutsche marks delivered. This event severely disrupted CHIPS, the main clearing system for US dollars, led to a collapse in trading in the US dollar/deutsche mark market and even resulted in disorder in the inter-bank money markets. This problem is widely recognised and is a focus of attention of central banks around the world.

IV. STANDARD INSTRUMENTS OF BANK REGULATION

30. This section of the paper provides a description of the most standard instruments of bank regulation: deposit insurance, capital adequacy requirements and lender of last resort. These three policies are linked one with the other. Deposit insurance protects the smallest depositors from a bank bankruptcy and prevents bank runs. Capital adequacy requirements are necessary in order to make sure that bank managers follow a responsible credit policy, in the absence of an effective control on the part of depositors. Lender of last resort policies further reduce the risk of banks bankruptcies providing banks with Emergency Liquidity Assistance facilities that are designed to avoid that temporary situations of illiquidity lead to the insolvency of the bank.

Deposit insurance

31. Deposit insurance is a guarantee that all or part of a depositor's debt with a bank will be honored in the event of bankruptcy. The specific form of insurance schemes can vary in a number of ways, including the fee structure (flat fee versus variable, risk-related fees); the degree of coverage (full versus partial coverage, maximum limits); funding provisions (funded versus unfunded systems); public versus private solutions; compulsory versus voluntary participation.

32. Deposit insurance reduces (and in most cases eliminates entirely) the incentive to "run" on the bank in the event of financial difficulty. Therefore it reduces the possibility that a

[14] Benston and Kaufman (1995), p37.

temporary situation of illiquidity and rumors on the insolvency of the bank actually lead to the failure of the bank. Furthermore, deposit insurance prevents the "chain reaction" that can also be started associated by the run on a single bank, so that it reduces the possibility of contagion in the banking system.

33. A drawback of its introduction is however the fact itself that from the point of view of the depositor, deposit insurance makes all banks equally attractive. It almost completely removes the incentive on the depositor to determine the risk of a bank and the need for the bank to compensate the depositor for bearing bank-specific risk by including a bank-specific risk premium in the interest paid to the depositor. Similarly, the depositor faces little incentive to diversify her portfolio of assets held in banks.[15]

34. The effect of deposit insurance on the incentives of the bank depends upon the nature of the insurance contract (and also on any other complementary regulatory measures). In particular, the effect of the deposit insurance on the bank will depend on whether or not the insurance premium paid by the bank depends on the individual bank's risk.

35. In the case where the premium is completely unrelated to the risk of a particular bank (i.e., the "fixed fee" system), there is clearly an incentive for the bank to attempt to increase its profits by either increasing its revenues (by lending to higher return but riskier projects) or by reducing its costs (by reducing its reserves). Both actions increase its risk. This is the well-known "moral hazard" problem of deposit insurance. Fixed fee deposit insurance creates incentives for banks to take on more risk in their operations than they would without deposit insurance. "This effect was apparent almost as soon as deposit insurance was adopted in the 1930s, when bank capital ratios dropped from 15% to around 6%"[16].

36. Deposit insurance, especially if extended to all deposits, by reducing the market incentives for prudent management, may have the perverse incentive of making banks riskier.[17] When this moral hazard extends across all financial institutions, the macroeconomic consequences can be very significant. .

37. The problem of moral hazard and the need for additional regulatory measures can be reduced if the insurance premium is related to the risk of the insured bank. "An efficiently organized insurer would graduate insurance premia according to the risk of the bank's asset portfolio and the adequacy of its capital holdings. Such a system would minimize the danger of

[15] At least as long as the size of the deposit is less than any "ceiling" on the amount per deposit insured (100,000 dollars in the US). Note however how this "ceiling" is only 20,000 Euros in the EU exactly in the attempt not to exacerbate such problem.

[16] Parry (1992) , p 14. The consequences of the "moral hazard" can be clearly seen in the "S&L crisis" in the US of the early 1980s. In the case of S&Ls "the insurance premium was set by statute in 1950 at 1/12 of 1% of the assessable deposits and was the same for all insured institutions regardless of the riskiness of their assets or the size of their equity capital or the capability of their management. "The holder of an insured account had no reason to be concerned with the safety or soundness of the particular institution in which he had invested, or to require a higher return commensurate with higher risk. ... From the standpoint of the management and owners of an insured S&L, this system created a constant inducement to take added risks with their expected higher returns, depositors would not demand higher interest and the FSLIC could not raise its premium in response". Scott (1989), p37.

[17] "Ironically, the introduction of government regulations and institutions in the US intended to provide protection against the fragility of banks appears to have unintentionally increased both the fragility of banks and their breakage rate. By providing a poorly designed and mis-priced safety net under banks for depositors, first through the Federal Reserve's discount window lender of last resort facilities in 1914, and then reinforced by the FDIC's deposit guarantees in 1934, market discipline on banks was reduced substantially. As a result, the banks were permitted, if not encouraged, to increase their risk exposures both in their asset and liability portfolios and by reducing their capital ratios. …. T(t)his represents a classic and predictable moral hazard behavior response". Kaufman (1996), p22.

adverse incentive effects ... Under such a system, the individual bank bears the consequences of a higher risk portfolio or a lower capital-deposit ratio, in the form of a higher insurance fee."[18]

Capital adequacy requirements

38. One regulation which exists in most countries is some form of capital adequacy requirement. "Capital adequacy requirements can take a variety of forms. Most countries know a minimum level of required capital (an absolute amount). Beyond that, many countries require the maintenance of some capital - or solvency - ratio; that is, a minimum ratio between capital and an overall balance sheet magnitude, such as total assets or liability, or some weighted measure of risk assets."[19]

39. However, capital-adequacy requirements do have certain difficulties:

(a) First, it is difficult to design capital-adequacy requirements in a sufficiently sophisticated way. For example even though the 1988 Basel rules on capital adequacy for banks categorizes assets and assigned a "risk-weighting" inevitably differences in risk were overlooked between individual assets. One consequence was that banks tended to search for the most risky assets within a risk class, encouraging "banks to go up the yield curve in pursuit of a return on capital".[20] In effect, the moral hazard problem re-emerged within the constraints of each regulatory risk class.

(b) A particular problem can arise with inter-bank lending. If inter-bank lending is treated favorably for capital-adequacy purposes in order to promote the liquidity on the market, banks may, perversely, be given incentives to lend to other banks in difficulty, increasing the risk of contagion and removing one of the more important disciplines on bank risk-taking.

(c) Third, with technological advances, innovation in financial products is rapid. Regulations, in contrast, might be changed not sufficiently frequently and only "catch up" with current developments.

(d) Fourth, in some cases the adoption of new financial products is hindered by lagging regulatory developments, delaying and stifling the pace of innovation.

40. Partly as a result of an increasing recognition of these problems, the Basel Accord was modified in 2004 introducing more sophisticated ways of computing capital requirements and increasing the focus on risk-management policies and systems in banks. In particular the new regulation, which will start to be implemented from the end of 2006, encourages banks to develop, with supervisory oversight, their own systems to compute minimum capital requirements. Furthermore Basel 2, by improving the flow of information to supervisors and the public on banks financial conditions, assigns a greater role to supervisory and market oversight in reducing excessive risks in banking activities.

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[18] Baltensperger (1989), p8.
[19] Baltensperger (1989), p13.
[20] Charles Dallara, Chief Executive of the Institute of International Finance, reported in Financial Times, Wednesday, November 19, 1997.

Lender of last resort

41. In most countries the central bank or the government have an explicit (or implicit) policy of providing assistance to banks facing financial difficulties

42. These lender of last resort interventions should be strictly limited to illiquid banks, easing only very temporary liquidity problems faced by banks (Emergency Liquidity Assistance), not extending also to help insolvent banks. In fact, whenever the lender of last resort assists insolvent banks, its intervention has the same consequences of a flat-rate unfunded deposit insurance, giving banks a strong incentive to adopt a riskier position than otherwise.[21] As with deposit insurance, when such incentives extend across the financial system, the macroeconomic consequences can be severe.

Moral hazard and the Asian financial crisis

In the mid 1990's, several countries in South-East Asia experienced a severe currency and financial crisis, on a scale that was almost entirely unforeseen, involving collapses in domestic asset markets, widespread bank failures, bankruptcies on the part of many firms and a very severe economic downturn.

The crisis represents something of a puzzle for macroeconomists. None of the fundamentals that drive traditional currency crises seem to have been present in any of the afflicted Asian economies. On the eve of the crisis all of the governments were more or less in fiscal balance; nor were they engaged in irresponsible credit creation or runaway monetary expansion.

In a paper written at the bulk of the crisis, Paul Krugman attempts to explain this puzzle, focusing on problems with bank (non) regulation in these countries. He argues that a key common feature was that the liabilities of financial intermediaries in these countries were perceived as having an implicit government guarantee, but that the financial institutions themselves were essentially unregulated and therefore subject to severe moral hazard problems.

To be sure, the government guarantees were not explicit. "However, press reports do suggest that most of those who provided Thai finance companies, South Korean banks, and so on with funds believed that they would be protected from risk - an impression reinforced by the strong political connections of the owners of most such institutions. In practice, moreover, these beliefs seem to have been for the most part validated by experience".

In the presence of government guarantees and a complete absence of prudential regulation, Krugman shows that banks have an incentive to continue lending as long as there remains any possibility at all that the lending will yield a positive return. This has the effect of bidding up asset prices to the point where they reflect their highest possible return, which can be several times higher than prices in an efficient market. The inflated value of assets improves that apparent financial position of the financial institutions, permitting more lending, and so on.

Krugman argues that a widespread perceived risk that government would decide to abandon the implicit debt guarantees is sufficient to lead to a financial crisis in which plunging asset prices undermine banks, and the collapse of the banks in turn ratifies the drop in asset prices. The "self-fulfilling prophecy" component of this story can help explain why an asset value down-turn in one country can rapidly spread

[21] It must however be said that it may be very difficult in practice to immediately distinguish an illiquid from an insolvent bank.

to others, in what is traditionally been called “contagion”. The moral of the story is either to impose stringent prudential regulatory controls or abolish the government guarantees.

V. REFORM OF BANK REGULATION AND MARKET POWER

43. On the credit side competition between banks has led to lower spreads and greater care in financing sound projects. Claessens and Laeven (2005) write:

> “More competitive banking systems are better in providing financing to financially dependent firms. …. There is support for the view that more competition may reduce hold up problems and lower the cost of financial intermediation, making financially dependent firms more willing to seek (and more able to obtain) external financing”

Furthermore in most countries, including developing ones, recent market developments have led to strong rivalry by non bank financial institutions for the supply of some banking services, for example consumer credit or factoring services to small and medium size firms. This implies that banks market power is somehow disciplined also by non banks.

Ensuring that banks are properly informed of the debt exposure of potential borrowers

44. Especially in developing countries, however, competition among banks may be impaired because information on the credit worthiness of potential borrowers is not readily available. Without a proper supplier of information on borrowers credit worthiness, each single bank has an informational advantage over any other bank on the credit worthiness of its customers. New banks will be very reluctant to lend to customers of other banks, if they are not fully and readily informed on the total debt exposure of each potential borrower. A competitive financial market, where banks compete for customers and potential borrowers choose among alternative banks as suppliers of funds, can only develop if banks are fully informed on the total exposure of each customer. Otherwise, if information is privately held by each bank, the market for credit will be segmented and banks will only lend to customers they personally know.

45. Relationship banking is particularly efficient when firms are small and accounting rules are not very effective. On the other hand a marked based system is particularly effective when firms are relatively large and accounting statements transparent. Moreover, “limitations on competition in a relationship-based system do not just give the financier (market) power, but also strengthen his incentive to cooperate with the borrower”[22]. This implies that a relationship-based system tends to smooth firm specific shocks intertemporally, while an arm’s length system is much less able to provide such contingent insurance. On the other hand relationship-based systems, because of the illiquidity of the financed assets, have an incentive to increase financial risk more than arm’s length systems. Market based financing “permits more flexibility in explicit contracts, which allows the system to absorb adverse shocks. Moreover the healthy can be distinguished from the terminally ill after a shock and can be dealt with differently – not everyone has to sink or swim together as in the relationship system”[23].

[22] See Rajan and Zingales (2003) p. 12.
[23] See Rajan and Zingales (2003) p. 19.

46. Relationship banking does not imply that potential borrowers do not have but one choice with respect to the bank that would assist them. There can be strong competition among banks also with relationship banking. In fact, in some countries, where the banking industry is sufficiently competitive and the industrial sector is sufficiently developed, each local bank may be willing to invest in order to develop a credit relationship with each local firm.

47. In many ways the two systems (arms-length and relationship banking) coexist in the same economy. Regulators should therefore not impose or favor one system over the other and should introduce regulatory provisions that are as much as possible neutral with respect to the type of relationship between banks and their creditors.. Regulators should therefore maintain a centralized system of monitoring the full exposure of different firms with respect to the banking system, and more in general with respect to the financial sector at large, requiring all financial institutions to communicate to the regulator all loans granted to a given (consolidated) borrower and their degree of utilization. The increase in transparency that such a system of centralized monitoring of debt exposure would provide, may help the development of arm's-length financing, and in any case reduce the market power of each bank with respect to its customers.

48. Antitrust authorities should use their advocacy powers to ask for such centralized reporting of debt exposure to be undertaken. Their role can be very important because they would advice on how to collect the information centrally without, at the same time, promoting collusion among market players.

Regulatory reform, competition and depositors' switching costs

49. While, in many countries banks benefited from the new opportunities originating from regulatory reform by offering new and improved financial services to customers, switching costs for consumers remained quite high, so that competition between banks did not increase proportionately. There is now substantial evidence that the widening range of services offered by banks was not associated with a significant increase in the elasticity of each bank residual demand (as should have been expected because of greater competition). The effect of liberalization on the market power of banks with respect to customers of banking services was probably not too strong.

50. In recent decades, besides the traditional deposit-taking banks have entered quite a number of new related markets, such as (among others):

- Credit cards services, paying bills for depositors
- Consumer loans
- Mortgages
- Life insurance
- Financial consulting; Management of investment funds; Asset management

By providing all these services under one roof, banks reduce the transaction costs depositors would have faced had they been obliged to negotiate for receiving these services with a number of different providers. At the same time, however, by offering all these services, banks have made it more costly for depositors to switch bank. In fact should depositors decide to move to a new bank they would need to: 1) receive new credit cards (with a different number and expiry date) that would need to be communicated to any service provider, for example the cable TV company, should its bills being paid by credit card; 2) inform the new bank about all utilities whose bills were being paid by debiting the depositor checking account; 3) transfer the deposit

of all purchased stocks or bonds to the new bank; 4) maintain the checking account of the old bank just to service the mortgage; 5) communicate to all correspondents the new banking coordinates. The increase in switching costs tends to make steeper the residual demand curve each bank faces, so, even though competition may be increased in each of the markets where the bank expanded, the overall market power of each bank is increased, at least with respect to existing depositors. Or, to say it differently, in order for a bank to convince depositors of another bank to switch, the improvements in the quality of services it offers must be much larger than it would be the case in the absence of switching costs.

51. Depositors may also face switching costs because of strategic behavior on the part of banks. For example while opening a checking account may be free, banks may require that a high fee be paid when closing an account. There are good reasons why a policy of charging for closing an account would be followed by all banks and would not be competed away: Each bank benefits by market segmentation and no bank benefits by unilaterally reducing exit costs.

52. This is why it is unlikely that banks would engage autonomously in switching costs reducing activities, given that this would imply reducing profits for each bank and also for the industry as a whole. Pro-competitive rules and regulations may contribute to make switching easier, so as to ensure that all the benefits originating from greater competition actually reach consumers.

53. Regulation could impose on all banks disclosure rules with respect to all the costs involved in switching, so that consumers are made aware of these costs and competition among banks may indeed prove to be very useful.

54. With the advent of the internet, banking is no longer necessarily a local industry, not even for the smallest depositor, at least in countries with widespread internet literacy. Since banking technology is the same across the world it is extremely important that regulation does not limit the extent of the market with unjustified restrictions. This is particularly important in jurisdictions that use the same currency. For example, the introduction of the Euro in 2002 could have made depositors indifferent as to the nationality of the bank where they would deposit their savings, leading to a very significant enlargement of consumer choices and of competition. Notwithstanding the regulatory interventions in such directions, such as with regulation (EC) 2560/2001 on cross-border payments in the Euro area, the high costs traditionally associated with dealing with foreign banks have remained. As a consequence, the residual demand of a bank localized in one country remained substantially equal to what it was before the Euro, while the removal of the higher costs associated with cross border transactions would have probably led to a significant increase of the elasticity of its residual demand.

55. Antitrust authorities should use their advocacy powers to push forward the pro-consumer agenda.

VI. BANKING AND THE FINANCING OF DEVELOPMENT

56. Cross country comparisons show the importance of a well developed banking sector for achieving both long term economic growth and the reduction of poverty. Countries with better developed banking systems and capital markets have shown higher growth rates[24]. However the

[24] See World Bank (2001)

direction of causality is not always clear. In particular, need property rights and contract laws be firmly in place before a viable financial sector is developed? Is the modernization of the banking sector a prerequisite for economic growth or is the other way round? What is the role of the public sector in the financing of development? This section will try to provide the competition authorities view, drawing on the existing literature and on the responses to a questionnaire delivered to six countries: Brazil, Hungary, Indonesia, Mexico, South Africa, South Korea.

57. Finance is always necessary for growth. In particular ongoing business need finance for operation and for expansion. The same is true for launching new business enterprises. Households need to have safe deposits, access to the payment system, to mortgages and consumer loans. In this respect the experience of many developing countries show that the banking sector is generally responding well to the needs of the wealthy households and of the established firms. More in general, banking seems to develop well with firms and people that are able to offer a collateral or have formal employment so as to provide some guarantee with respect to future income, less well with people and firms that are unable to offer guarantees. However, while in developed countries this second group of customers is relatively small, in developing countries it represents the majority, so that banks tend to provide services only to the minority of the population. In banking, while the competitive solution with little regulation is appropriate for these existing banks so as to eliminate distortions, favoritism and high interest rate spreads. As ana example, the Pakistani competition Authority in its submission to the OECD Global Forum on Competition in February 2005 writes:

> "The financial sector was deregulated and … with the economic liberalization, new banks, financial institutions, leasing companies, housing finance, investment companies and foreign banks have come up, which has created a competitive milieu"[25].

58. Regulatory reform and competition are able to expand the reach of banking to the underprivileged. On the one hand, especially in countries where the majority of potential borrowers do not have a collateral to offer, conventional banking may lead to a non optimal equilibrium, where quite a number of low risk project are not financed and high-risk borrowers end up having to pay higher interest payments. On the other hand technical progress and flexible regulation have made it possible to provide banking services also to the poor. For example Dymski (2003) writes:

> "Lemon Bank (a microcredit bank)… offers credit and debit cards and savings accounts to the unbanked. Its minimum amount are tiny, and checking services are available without annual fees. … Lemon Bank, which has 3600 access points, many in favelas and in drugstores, is about to launch a media campaign aimed at opening 100,000 new accounts by year's end."

59. As for the lending side, in recent years in many developing countries specialized lending institutions started to use unconventional methods to lend successfully to the poor, starting what is now known as microcredit. Considerable evidence shows that such unconventional lenders were able to lend to borrowers that no conventional borrower was willing to attract and nonetheless performed much better, in terms of financial self sufficiency and repayment rates, than would conventional banks in comparable loans. The reason of this success, that is not limited to the Grameen Bank in Bangladesh, is the use of unconventional methods of risk reduction: forming groups of borrowers that are jointly responsible for each other's loans (joint liability) and intense monitoring of clients, relying heavily on the promise of repeating the loan.

[25] See OECD (2005)

60. A recent World Bank report on rural financial services[26], comparing the competitive low interest rates that microcredit offers with the regulatory solution of subsidized low interest rate, concludes that the competitive solution of allowing microcredit institutions to develop is far superior. Indeed subsidized credit leads to excess demand and the decision on which firm to lend does not depend so much on the relative profitability of the underlying project, but mainly on other considerations (political connections, corruption etc.). The World Bank report outlines in the following table, the cost and benefits of the old and the new paradigm:

Table 1 Primary features of the old and new paradigms in rural finance

Features	***Directed Ag. Credit Paradigm***	***Financial Systems Paradigm***
1. Chief aims	Boost agricultural production Reduce poverty	Reduce market imperfections and Transaction costs for income expansion and poverty reduction
2. Role of financial markets	Help the poor Stimulate production	Intermediate efficiently
3. View of users	Beneficiaries: borrowers	Clients: borrowers and depositors
4. Subsidies	Heavily subsidy dependent	Increasingly independent of subsidies
5. Sources of funds	Vertical: governments and donors	Horizontal: primarily voluntary deposits
6. Associated information systems	Dense, fragmented, and vertical	Less dense and mainly horizontal
7. Sustainability	Largely ignored	Major concern
8. Outreach	Mostly ignored	Primary concern
9. Evaluations	Credit impact on beneficiaries – mainly primary data	Performance of financial institutions – Mostly secondary information

Source: World Bank (2003)

61. In the past decade many micro-credit supplying institutions, which originally were State owned and loss making, were progressively privatised and deregulated, increasing both their efficiency and their profitability. Besides the Grameen Bank in Bangladesh which is well known, BancoSol in Bolivia, Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, Bank Rakyat Indonesia (BRI) and the National Micro-finance Bank (NMB) in Tanzania are all successful examples of efficient micro-credit. They all show the important role micro-credit institutions in developing countries can play in fostering rural development and how more effective market based institutions can be with respect to direct Government interventions for directing credit to specific markets at regulated low interest rates. Important conditions for success include "independence of decision-making and a high level of accountability for financial performance"[27].

Three examples of successful micro-credit

Banco Sol started in Bolivia in 1987 as a non-profit foundation and in 1992 was turned into a private bank, the first bank in the world dedicated exclusively to microfinance. By 2002 Banco Sol became the

[26] World Bank (2003)
[27] See World Bank (2003)

largest institution in Bolivian financial markets in terms of the number of loan contracts (35% of the total) with an outstanding loan portfolio of $ 67 million (see Santos 2003). The profitable strategy of Banco Sol was to lend to previously unbanked firms and individuals, reducing risk with joint liability contracts and, as a consequence, charging much lower rates than those available on the informal money market, before its entry the only available source of funds for its clients. (Andersen and Nina, 2000).

The experience of BAAC in Thailand shows the important role that competition oriented regulatory reform in banking can have on the profitability of microcredit institutions. BAAC depended initially exclusively on capital from government, and in the early 1970's displayed a chronic funding shortage and loan recovery rates as low as 51%. At that time the solution was additional regulation and the Bank of Thailand adopted an agricultural credit policy in 1975, by which commercial banks were obliged to lend a share of their portfolio to agricultural sector. Many of these banks, instead of lending directly to agriculture, deposited their funds with BAAC. As a consequence, the structural shortage of funds suffered by BAAC disappeared. Banking reforms undertaken between 1988 and 1996 eliminated interest rate ceilings and restrictions on the opening on new branches, eliminating also the constraints on commercial banks on agricultural lending. Nonetheless the efficiency of Baac strongly increased and rural deposits became its main source of funds. By the late nineties its branches had grown from 82 to 535, its outreach and savings mobilization had raised at such point that it did not even suffer from the financial crisis of 1997 (see Seibel, 2000).

BRI in Indonesia has been a major provider of microfinance since 1984. By 1989 BRI was able to finance its lending activity with rural deposits. According to Seibel (2000)

> "BRI benefited form interest rate deregulation and a management initiative to commercialize operations by transforming its sub-branches into self-sustaining profit centers. For example it offered its staff profit-sharing incentives. The bank covers its costs form the interest rate margin and finances expansion from its profits; its long term loss ratio is only 2.1 percent."

BRI, like BAAC, remained profitable even during the Asian crisis. As Seibel (2000) reports it was the only profitable entity among the government-owned banks. .

NMB was created in Tanzania after the privatisation in 1997 of the loss making rural branches of the National Bank of Commerce. After an internal restructuring and a thorough reform of NMB pricing policy, by 2002 NMB had become profitable without having to close any of its branches. As the World Bank (2003) reports:

> "A key initiative has been the development and rolling out of microfinance products, mainly small (average $400). As of June 2002, 10.000 loans had been disbursed through 36 of the bank's 104 branches, with a level of arrears below 2%."

VII. THE SCOPE AND ROLE OF COMPETITION LAW IN BANKING

62. We turn now to the interaction between competition law and banking regulation and, in particular,to an explanation of why the full application of competition law in the banking sector by a national competition authority is desirable, and in no way incompatible with an effective regulatory framework.

- *Competition law should fully apply to banks(in parallel with banking regulation)*

Item 4 of the OECD Policy Recommendations on Regulatory Reform specifies that sectoral gaps in coverage of competition law should be eliminated "unless evidence suggests that compelling public interests cannot be served in better ways". This is echoed in the Financial Services chapter:

"It is important that the rigorous concern for the pursuit of competition policies that has been a key element of past policies toward the financial services industry be continued. Basic principles of competition policy should be applied in financial services as should competition law, subject only to clearly justified exceptions needed for prudential reasons or other overriding public policy objectives".[28]

As an aside it is, of course, necessary that the national competition laws are up to the task[29]. In particular, the national competition laws must be generally-applicable, flexible enough to take full account of differences in different sectors, and must be designed to promote economic efficiency objectives.

- *Banks should not be subject to their own, "special" competition rules but should be subject to general competition rules.*

  Very often it is proposed that a sector be subject to its own particular set of competition rules on the grounds that the sector is unusually important or in some other sense 'special'. The proposal should be treated cautiously. Violations of competition rules fall within very general categories and are flexible enough to accommodate any sector specific characteristics. Special competition rules are not only unnecessary, but they may also undermine enforcement. There is a very thin line between sector-specific competition rules and continued regulation, especially if the special rules are to be enforced by the former regulator. There is a danger that sector-specific enforcers may adopt an understanding of competition that is overly congenial to the industry's traditional mode of operation instead of promoting a competitive regime.[30] As explained in the following box, sector-specific laws are more vulnerable to being changed and enforced in the interest of the regulated industry, rather than in the interest of the economy at large. General laws, on the other hand, tend to be more immune and therefore more robust and long-lived.

Sector-Specific Or Generic Regulation?

Are sector-specific competition rules preferable to generic competition rules? Is it preferable to have a sector-specific competition enforcer or an economy-wide competition authority? The answer is that, wherever possible, generic regulation and generic enforcement is preferred to the sector-specific approach.

The reason is straightforward. Sector-specific institutions encourage sectoral lobbying and are more vulnerable to industry capture. Experience suggests that firms in a regulated industry will, over time, seek to influence their governing regulatory regime to their own purposes - for example, to restrict competition. In particular, the regulated firms will seek to use political pressure - on policymakers and regulators - to influence the legislation or the enforcement of the regime.

[28] OECD (1997b), p98.
[29] See OECD (1997b) p255.
[30] OECD (1997b), p256.

In contrast to an economy-wide regulatory regime, sector-specific regulation is much more vulnerable to this form of lobbying. The larger and more diverse are the affected firms, the harder it is to form the coalition of common interests necessary to maintain a sustained lobbying effort. Generic legislation, which applies to a large number of firms with different interests, is therefore more stable and more immune to the tendency for regulation, over time, to operate for the benefit of the regulated industry.

The same is true for the regulatory body itself. Experience suggests that over time, through the sustained lobbying efforts of the industry, sectoral regulators tend to be influenced by the specific interests of the industry they regulate. That is, it becomes increasingly harder for the regulatory body to distinguish the public interest from the interest of the industry. "Regulators, in direct contact with those whom they regulate rather than with consumers, tend to identify more with suppliers and their problems than with the general public and its problems".[31] A generic regulator with experience in a large number of industry sectors is able to more easily discern self-interest in the arguments of the regulated firms and is less likely to be peopled with staff who see a bright future for themselves in the regulated industry.

Importantly, a sector-specific regulator may also become an obstacle for regulatory reform. Over time, the interests of the regulatory body and the regulated industry may converge - both have a strong interest in the continuation of the sector-specific regulation, even where the underlying reason for the regulation no longer exists. Indeed, where the underlying reason for the regulation disappears, sector-specific regulators have a strong incentive to find alternative reasons for regulation, in order to ensure its continued survival. A generic regulator, in contrast, has little interest in the continuation of any specific regulation and therefore can act as an important influence, where appropriate, for regulatory reform.[32]

More generally, a sector-specific regulator has incentives to argue against structural reforms or other policy actions which the expand the role of competition (and therefore reduce the responsibility of the regulator) within the regulated sector.[33]

In addition, a generic law is likely to develop a larger body of case law more quickly than a sector-specific law.

Where generic competition rules apply to the financial sector, banking supervision authorities, if charged with their enforcement, may be naturally led to take into account, in a non-transparent way, concerns relating to the stability of banks and to adopt an improper regulatory approach in the application of competition rules, for instance, as far as the choice of remedies is concerned.

Finally, also due to the removal of most regulatory line of business restrictions in many countries, it is becoming increasingly difficult to design an effective and stable system in which a subset of markets or firms is not under the jurisdiction of the economy-wide competition authority but of a sector-specific competition law enforcer.

- *Antitrust law should be enforced by the general antitrust authority, not by the specialized sectoral regulator*

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[31] Benston (1973), p221.

[32] "Sector-specific agencies may resist the pro-competitive thrust of reform because of self-interest. An agency whose chief purpose is to regulate an industry ensures its own survival by keeping regulation in place. The general jurisdiction competition-enforcement agency, which has no such concern with respect to any particular industry, may be able to assess competitive conditions and opportunities more impartially". OECD (1997b), p256.

[33] There are other arguments in favour of generic legislation. For example, the development of a body of case law is likely to be more rapid under industry-generic legislation, enhancing industry certainty. It might be argued that industry-specific measures are preferable when there are serious shortcomings in the generic competition law. In this case, however, rather than introduce sector-specific rules, these shortcomings should be addressed as soon as possible.

Again, as the box emphasizes, there are strong reasons for preferring that competition rules be applied by the antitrust authority and not by the sector-specific regulator. Should sectoral expertise be necessary for competition decisions, this can be addressed through formal or informal consultation of the sector regulator by the competition authority. The OECD Report on Regulatory Reform notes:

"Reformers should pay special attention to experiences of agencies such as the US Interstate Commerce Commission and the Civil Aeronautics Board. Though originally charged with ensuring competition, these two regulators became means for maintaining cartels. The problems persisted after the old agencies were abolished. For several years after the US airline industry was deregulated, jurisdiction over airline mergers rested with the Department of Transportation, rather than the antitrust agencies. The Department approved several combinations leading to significant market power in several city-pair markets, despite vigorous objections from the antitrust authorities. The same thing happened in the case of a railroad merger approved by a special Board within the US Department of Transportation".[34]

63. The process of regulatory reform in the banking sector, which has occurred over the past two decades, has significantly increased the role of competition in the banking sector. At the same time, there has been a movement (in those countries which had partially or totally exempted their banking systems) to extend the jurisdiction of national competition laws to include banks:

- Finnish legislation has been largely emended in 1998, removing special provisions for bank mergers. The Irish Competition Act 2002 assigns to the Irish competition Authority all powers on mergers, including banks.
- In France bank mergers fall now fully under the general antitrust provisions. The French Authorities have to consult with the banking regulator before taking a decision and should provide a full explanation, should they decide to deviate.
- In Canada the Competition Act of 1986 brought bank mergers and interbank agreements within the scope of the general competition law (subject to a general right of authorization of mergers by the Minister of Finance). Prior to this new Act, interbank agreements and mergers involving banks were exempted from competition law.
- In Germany special treatments for banks under the competition Act have been progressively eroded and all remaining privileges have been lifted as of January 1 2000.
- In Portugal the new Competition Act applies fully to banks.
- The European Court of Justice confirmed in 1981 that EC competition law has always fully applied to the banking sector.

64. In almost all jurisdictions Ministries of Finance or Central Banks have the duty to control bank mergers for stability reasons and for ensuring the safety and soundness of the institution and its managerial competency, while competition authorities control them on competition grounds. Only in very few jurisdictions competition and stability concerns are pursued by the same institution:

[34] OECD (1997b), p256.

- In Brasil the Central Bank has full responsibility over bank mergers (both for stability and for competition considerations).
- In South Africa, the Minister of Finance for "public interest" objectives can exclude the competition authorities' jurisdiction over bank mergers.
- In the US, under section 18(c) of the Bank Merger Act of 1966, the Comptroller of the Currency (OCC) for national banks, the FDIC for federally-insured, state-chartered banks that are not members of the Federal Reserve System and the Board of Governors of the Federal Reserve System for state-chartered banks that are system members, must conduct their own competitive analysis of bank mergers. However in most transactions only DOJ and a single bank regulatory agency actually are involved and obtain a competitive factors reports from the Attorney General of the United States before approving a bank merger.
- In Italy the antitrust law provisions apply to banks but they are enforced by the Central Bank (only in so far as the conduct or the merger produces effect on credit-making and deposit-taking markets). In such cases the antitrust authority is obliged to provide an advice. In all other circumstances the antitrust authority is fully responsible.
- In Korea, the Financial Supervisory Commission, when considering an approval of a merger or an acquisition, has to have prior consultation with the Korea Fair Trade Commission on the effect of the operation on competition.

VIII. THE APPLICATION OF COMPETITION LAW IN THE BANKING SECTOR WITH A PARTICULAR EMPHASIS ON MERGERS

65. We turn now to the issues that arise in applying competition law in the banking sector. In particular we will address some of the problems arising in merger control, as an example of how a competition authority applying competition law can bring added value (for example, in the field of market definition, which has been under discussion for quite some time). For reasons of concision, restrictive agreements and abuse of dominance in banking are not analyzed in detail in this report.

66. During the last fifteen years there has been a decline in the number of banks in many OECD countries.[35] Reasons for the consolidation of banking activity include (amongst other factors) the relaxation of restrictions on the geographic area that a bank can serve, and elimination of other structural regulations that may have served to shelter relatively inefficient banks from competition.[36] An additional factor is the adoption of new information processing technologies which has increased the efficient scale of operation in some bank activities.[37]

Framework for analyzing bank mergers[38]

[35] In the U.S., for instance, the number of banks declined monotonically from 14,230 in 1983 to 10,313 in 1994. Over this twelve year period, entry of 2,416 newly chartered banks more than made up for the 1398 banks that failed and exited. The net decline represents a wave of merger activity among banks in the U.S. which has no parallel since the Great Depression. Not only has there been a large number of mergers in the recent past, but a number of individual mergers that have taken place during the 1990s rank among the largest U.S. bank mergers ever, in terms of the real value of the assets involved and also in terms of the share of total U.S. bank assets accounted for by the merging banks. Rhoades (1996a) , Rhoades (1997) ,.

[36] Rhoades (1996b) , Rhoades (1997), Berger, Kashyap, and Scalise (1995)

[37] Description and some discussion of changes in regulations and other forces relevant to the competitive analysis of banking markets in Europe can be found in Gual and Neven (1992) .

[38] This section closely follows Rozanski and Rubinfeld (1997).

67. In assessing the likely effect of a bank merger on competition, in principle one should consider whether the merger could create or facilitate the exercise of market power, where market power is defined as the ability of firms to increase price or reduce quality from pre-merger levels. A merger could have anticompetitive effects by making it profitable for a leading firm to exercise market power unilaterally, or by increasing the likelihood that firms in a market could successfully maintain a collusive outcome.

68. To evaluate the effect of a merger, it is essential to analyze the merger's impact on the range of services provided by banks. Banks sell a wide range of services or products, including deposit, loan, and investment services sold to retail customers; deposit, loan, and various other services sold to businesses, and also correspondent services, which are specialized services supplied by a relatively limited number of banks to other banks, often for resale to the ultimate purchaser. Trade finance, custody, check clearing services, and foreign exchange services are examples of correspondent services. Banks in some countries are restricted in their ability to offer underwriting services, insurance, and some investment products. There are fewer limitations on the ability of banks to offer these products in most other countries.

69. In general, the analysis of the likely effects of a merger on competition must take into account a number of factors. One factor is the possibility that prospective purchasers of a product would choose to substitute to alternative products in response to a small but significant increase in the relative price of the product. If such substitution would not occur in an amount sufficient to make the price increase unprofitable then the product constitutes a relevant product market. A second factor is the possibility that prospective purchasers could turn to alternative sources of supply, including firms that currently produce and sell the product in other geographic areas. If such substitution away from firms located in a given area would not be significant, then the area constitutes the geographic market. The possibility of significant new competition from entry by firms that don't currently produce or sell the product is a third factor[39].

70. The structure of competition in the relevant product and geographic market, including the number and relative competitive effectiveness of current market participants, affects the likelihood that a merger be anticompetitive. Other characteristics of competition in the market also affect the likelihood of anticompetitive effects. For example, if there is significant product differentiation, and if products sold by the merging firms are perceived by purchasers to be relatively good substitutes, than there is a greater possibility of unilateral anticompetitive effects. If firms have good information about the competitive actions of their rivals, and if competitive strategies can be revised quickly, then coordinated anticompetitive effects are more likely. Finally, in some countries competition law allows consideration of a possible efficiency defense - if a proposed merger holds the promise of real efficiencies that could not reasonably be achieved through other means, these efficiencies could serve to lessen concerns about the net effects of the merger on competition.

71. The analytical framework described above will result in different policy recommendations for bank mergers in different countries, because of significant differences in the structure of competition, the preferences of purchasers of bank products (and the set of alternatives they face) and the institutional context. The following paragraphs set out an indicative approach to the analysis of competition in the markets for small business loans and

[39] These are the arguments used by the DOJ/FTC in their merger guidelines in their hypothetical monopolist test for market definition.

consumer bank products, two bank products for which competition concerns tend to be the greatest.

Small Business Loans

72. Small businesses[40] typically have obtained a variety of credit products from banks, including mortgages on commercial property, and loans to purchase or lease vehicles, equipment, and other capital goods. In recent years however non banks have started to enter into this filed offering a number of credit products to small businesses, such as factoring, leasing and mortgages. On the other hand businesses that have a need for a line of credit for startup or working capital are likely to have a limited ability to substitute away from their bank.

73. It is not uncommon for small businesses to rely to a significant extent on personal credit, such as general purpose consumer credit cards or a second mortgage on a personal residence. These alternatives are likely to be viewed as inferior, however, because they are relatively high cost, and they put personal assets at risk. The question for antitrust analysis is whether, as a result of a merger, banks are likely to find it profitable to raise prices with respect to small business loans. The answer to this question depends on the willingness of businesses that would obtain a line of credit from a bank at prevailing prices to substitute to another bank or to alternatives in response to an anticompetitive price increase. The fact that some businesses use these alternatives at prevailing prices demonstrates the feasibility of substitution, but does not establish that such substitution would occur in an amount sufficient to make an anticompetitive price increase unprofitable; the analysis must attempt to quantify the likely magnitude of such substitution.

74. The next step in the analysis of the likely effects of a proposed merger on competition to supply small business lines of credit is the determination of which banks and which bank locations are able to compete effectively to supply the product. In the past there have been strong reasons why small businesses tended to obtain lines of credit and some other key bank products from nearby suppliers. In part, this was due to the information advantages a nearby supplier would have on local enterprises, coupled with a strong preference that some services used on an almost daily basis, such as transaction services (the provision of currency and coin, acquisition of credit card receipts, night deposits, and electronic funds transfers) and demand deposit accounts, be quickly accessible. The internet and internet banking may change all this, considering that credit to small businesses is mainly based on collaterals.

75. To the extent that banks finance investment on the basis of its profit opportunities, than local banks are relatively better placed, considering their superior knowledge of local business conditions which tends to make them better informed about the risks associated with a new business startup, while their proximity to local businesses tends to lower costs of monitoring performance and updating information about credit risk. Local banks are therefore likely to be able to identify small businesses that are better credit risks and compete successfully to win their business by offering relatively favorable terms. It is true that some banks and other providers of credit to small businesses are sometimes located a great distance away.[41] In the case of vehicle or equipment loans that are secured by the capital good being financed, the riskiness of the loan is reduced and the informational advantage of local banks is eroded. In the

[40] "Small" businesses are defined, e.g., by the US DoJ to be those with annual revenues in the range of one to ten million dollars.
[41] Wells Fargo & Co., a California bank, initiated a strategy in 1995 of marketing lines of credit to small businesses nationwide using direct mail. Some other banks have imitated this strategy. Oppenheim (1996) , Oppenheim (1997) More recently, Wells Fargo has solicited applications through its web page.

case of lines of credit, distant suppliers lacking a branch network or significant presence in a local market are likely to regard all but the most well-established small businesses as relatively high risks. Distant suppliers may compete successfully to make loans that the better informed, local lenders also identify as high risk, but they may not be competitive in the case of borrowers that local lenders identify as relatively good risks. It is competition to supply services to these borrowers that is at issue from a merger of local banks.[42]

76. In regard to the analysis of entry conditions, studies of entry in local banking markets show that entry appears to be driven largely by factors such as the growth of economic activity in the area and the current density of banks and branches, rather than by the measured profitability of incumbent banks. It seems unlikely that the entry decision would turn on increased profit opportunities in a relatively small activity such as small business lines of credit. In addition, new entrants may require several years to establish themselves as effective competitors to make small business loans, because of the importance of private information, reputation, and long-standing business relationships in this activity. The possibility of exogenous entry is an important factor to consider, but it may not be possible to count on quick and effective entry to counter the effects of an otherwise anticompetitive merger.

Consumer bank products

77. In the case of some important consumer bank products, such as home mortgages, car loans, and credit card loans and transactions services, distant banks and specialized non-banks are increasingly demonstrating their effectiveness as competitors. The analysis of consumer home mortgages and car loans bears some similarity to asset-backed loans made to businesses: the fact that the collateral is relatively easy to evaluate makes competing in this market easier for non-local suppliers. Credit cards in many countries are often marketed on a national basis by direct mail and telephone. Such credit card issuers rely on credit histories assembled by third-parties (where they exist) and on credit-scoring software that predicts credit risk. Credit-scoring algorithms have so far proven to be more useful in this application than in the case of small business lines of credit.

78. Consumers tend to prefer to obtain checking account services from a conveniently located supplier. Because many consumers who commute a significant distance to work consider a bank location near their workplace to be a good substitute for a bank location near home, the geographic market is relatively large. Also, in some countries (in contrast to the analysis of small business bank products) there are other non-bank depository institutions (such as thrifts or credit unions) which are active suppliers of consumer bank products. The advent and spread of ATMs, electronic funds transfer, and the development of home banking via computer or telephone raise the likelihood that local banks with branch networks lose their competitive

[42] In the case of a market such as that for small business lines of credit in which suppliers are significantly differentiated based on their locations, competitive interactions among firms located along a geographic continuum can be sufficient to conclude that the geographic market is much larger than would be suggested by the strong preferences of customers for local sources of supply. Each firm is constrained only by the few competitors in its immediate neighborhood, but the effects of competition at one end of the spectrum are transmitted from local area to local area and may be felt at a great distance. In theory, however, even if there is no break in the geographic "chain of substitutes," the exercise of market power over a limited portion of the spectrum may be profitable because the profits that can be earned by increasing price to inframarginal customers who lack good alternatives more than makes up for the loss of business at the margin. In the case of bank loans, the possibility of price discrimination simplifies the analysis, and may make it possible to define geographic markets that are quite narrow. Price discrimination in the case of small business loans is likely to be a successful strategy: significant arbitrage among borrowers is implausible, and banks can use information obtained in the loan application process to develop good information about the willingness of customers to substitute toward other suppliers. Banks can meet competition at the margin by lowering prices selectively to some customers.

advantage, and that geographic markets for consumer bank products become much larger. Also internet banking is quickly developing in many countries.

Cluster market approach

79. The methodology described above considers separately the effects of a bank merger on competition to supply each bank product. An alternative approach views the relevant product for analyzing bank mergers as the cluster of products and services that constitutes "commercial banking."[43] This cluster includes consumer loans and consumer banking services as well as business loans and products.[44]

80. Some have argued that the cluster approach is not appropriate because banks are not constrained to raise the prices of all services they offer uniformly. Banks would not be deterred from raising the price of one product, such as a small business line of credit, by the possibility that prospective loan customers would substitute to other products in the cluster, such as a checking account. Nor would an increase in the price of the loan be defeated by competition banks face to supply other products in the cluster.

81. On the other hand, others believe that the cluster market approach gives the right answer, especially if there were strong economies of scope in production, so that all banks supplied all products in the cluster in the same proportion and if there were strong complementarities in demand, so that all consumers consumed all products in the cluster in the same proportion. For example, in analyzing a merger of firms that produce shoes, it probably would not matter much to the conclusion if the analysis was done in terms of right shoes, or left shoes, or pairs of shoes.

82. In the case of the "commercial banking cluster", some firms in fact compete very effectively in supplying some, but not all, products in the cluster. In addition, although consumers and businesses do tend to purchase multiple services from their primary financial institution, they do unbundle purchases today, and would likely unbundle to a greater extent if their current bank increased prices of some products in the cluster. The cluster market approach appears to understate competition in the market by ignoring the role of specialized providers of some services.

83. The cluster market approach may overstate competition in the market by wrongly inferring from the existence of abundant competition to supply one product in the cluster that competition in other product markets is sufficient. For example, suppose that the relevant geographic market was defined by commuting patterns. This is sensible in the case of consumer banking products, for which consumers consider services from banks located near their home or near their work to be good substitutes. But the resulting geographic markets are sometimes far larger than is appropriate to analyze competition for many small business bank products, for which proximity of the bank to the place of business is key. In cases in which the structure of competition is not homogeneous throughout the broad geographic market, the cluster market approach may miss adverse effects of the merger on local competition.[45]

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[43] U.S. v. Philadelphia National Bank, 374 U.S. 321 (1963); U.S. v. Phillipsburg National Bank & Trust Co., 399 U.S. 350 (1970)

[44] In the U.S., the cluster market approach guides the decisions of the Federal Reserve Bank.

[45] The Australian Competition and Consumer Commission rejected the cluster market approach when analyzing the 1997 Westpac/Bank of Melbourne merger. The ACCC concluded that the geographic market for home loans was national, but that geographic markets for demand deposits and small business banking products did not extend beyond state boundaries. The existence of national competitors in the home loan market was correctly understood to be irrelevant to the competitive analysis of other product markets. Also the EC Commission does not follow a cluster market approach when defining markets in the competitive analysis of bank mergers.

IX. CONCLUSIONS AND RECOMMENDATIONS

84. This report has sought to review regulations governing banks in the light of established principles for good regulation. It raised the question of what, exactly, is the problem (i.e., the market failure) that (prudential) regulation of banks is designed to address. In particular, while there are some problems that need a regulatory intervention (protection of smallest depositors, proper regulation of banks settlements, mandatory information disclosures, risk adjusted stability concerns), for the rest the sector can be efficiently disciplined by market mechanisms and by antitrust law. The Report addressed then the importance of switching costs for increasing market power of each single bank, identifying regulatory solutions to reduce their importance.

85. In terms of recommendations, jurisdictions should:

- promote an open, competitive, banking environment without unjustified restrictions on entry, ownership or exit, resulting either from the rules to be applied or from enforcement practices;

- ensure that there is a proper separation between the enforcement of prudential regulation and of the general competition rules;

86. In addition agencies should:

- whatever the institutional setting, build good working relationships with the regulatory agencies and coordinate their efforts in reviewing particular matters.

- apply in enforcement the usual tools of antitrust analysis, including market definition, market power/dominance, remedies.

87. Finally, agencies in their competition advocacy functions should consider, as appropriate when competition concerns are raised, to advocate for:

- the elimination of exclusions from competition law for financial institutions;

- an environment where banks are informed in a timely and complete manner on the debt exposure of potential borrowers (in integrated financial markets also on an international basis), making sure to identify ways and precautions such that information sharing does not lead to restrictions of competition;

- a reduction of switching costs by depositors, for example by asking for disclosure rules, for example on the costs associated with the closing of an account or paying off a mortgage;

- in countries with a common currency, a reduction of transaction costs on cross border payments, including the creation of larger than national payment systems, so as to favor the development of larger markets and greater choices for consumers;

- a legal environment where the taking possession of collateral is possible without delay;

- especially in developing countries and consistent with maintaining a competitive market., the creation of a legal environment where financial institutions can reduce their risk by joint liability lending.

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AN INCREASING ROLE FOR COMPETITION IN THE REGULATION OF BANKS

APPENDIX

THE EXPERIENCE OF A SELECTED GROUP OF COUNTRIES

Brazil

Hungary

Indonesia

Korea

Messico

South Africa

Banking, competition and economic development – BRAZIL

QUESTIONS

Role of banking in financing business activity in your country

Question

1) Besides the traditional deposit-taking and credit-offering functions, what additional services are provided by banks in your country:
Services for depositors like:
- **Credit cards services, paying bills for depositors**
- **Consumer loans [auto, personal, bill paying, etc]**
- **Mortgages**
- **Life insurance**
- **Financial advisors; Management of investment funds; Asset management**

Services for firms like:
- **Banking services for firms (business liquidity loans, capital investment loans)**
- **Brokerage services**
- **Corporate banking services**
- **Investment banking (Stock Exchange listing, trading, clearing and settlement services)**

Answer

The services mentioned above are the main services provided by banks in Brazil and all of them may be provided for depositors and for firms. While insurance policies are sold by the banks, insurance is provided by insurance companies, many of them connected to the banks. Brokerage services that involve buying and selling on a stock exchange are provided only by brokers, but may be contracted through the banks.

Question

2) With respect to the list of financial services contained in 1) are there regulatory limitations that constrain the ability of banks to offer some of them? Are there regulatory limits on the ability of banks to lend?

Answer

Yes, in some cases there are regulatory limitations to the ability of the banks to offer some of the services mentioned above. The following comments seem pertinent:

<u>Services for depositors</u>
* *Credit cards services, paying bills for depositors* - credit cards services for certain commercial enterprises are not provided by financial institutions. However, when banks do provide credit card services, they are subject to supervision and regulation by the Banco Central do Brasil. There are no restrictions on paying bills for depositors.
* *Consumer loans [auto, personal, bill paying, etc]* - any credit operation above R$ 5.000 (approximately US$ 1.800) must be registered at the Public Credit Register, and the regulations on minimum provisioning (Resolution 2.682) and risk weighted capital requirements must be observed.

* *Mortgages* – the same provisions stated for consumer loans apply to mortgage loans.
* *Life insurance* – as already mentioned, the banks may sell life insurance products and the insurance activity is regulated by Susep (Private Insurance Superintendence), which is in charge of establishing regulatory requirements for the insurance companies (many financial conglomerates include banking institutions and insurance companies).
* *Financial Advisors, Management of Investment Funds and Asset Management* – the investment funds are regulated by CVM (Securities Commission) and the investment fund services must be segregated from other activities ("Chinese walls"), and there are also rules dealing with consumers protection and transparency. Banks may manage investment funds, as well as provide other services (custody, clearing, payment and settlement) for independent asset management companies.

<u>Services for firms:</u>
* *Banking services for firms (business liquidity loans, capital investment loans), brokerage services, corporate banking services, investment banking (stock exchange listing, trading, clearing and settlement services)* – there are no restriction for the provision of these types of services for firms, aside from certain brokerage services as mentioned above.
Regulation also establishes limits on the abilities of banks to lend – the maximum exposure per client is equivalent to 25% of the PR (PR means "Patrimônio de Referência" – Reference Net Worth and comprises tier 1 and tier 2 capital) and the sum of maximum exposures may not exceed 600% of the PR.

Question

3) **Considering each service as detailed in question 1), please provide a brief description of the market structure, considering that for most of these services banks compete also with non banks and that if the size of the market is local you should provide some sort of nation-wide averages:**
   (a) **is there a single provider for each product? Are there a few large providers? Are there many providers?**

Answer

In the markets there are several providers for these services, some are specialized in certain types of financing, others are not, such as the multiple banks. Under the supervision of the Banco Central do Brasil, aside from the multiple banks, there are commercial banks, investment banks, development banks, consumer finance companies, leasing companies, mortgage companies, real estate finance companies, micro-credit companies, development agencies, brokers and dealers.

Question

(b) **Is there one single consumer of the product considered? Are there a few large entities as major consumers? Are there many consumers?**

Answer

There are many consumers for the products considered.

Question

(c) **In geographic terms, how wide is the market for the products concerned?**
[are customers' branch/location dependent? What is the willingness of customer to use distant branches?]

Answer

Depending upon the region, financial services are widespread, whereas in others they are limited. In recent years, where correspondents for the banks have been contracted to perform certain financial services, all regions are now served with the very minimum. Financial institutions, as well as branch offices, are concentrated in the more advanced regions of the country. The use of internet

banking and ATMs is growing at a rapid rate, so that the need for customers to enter branches is reduced.

Question

4) **Please briefly describe the paperwork required to switch bank for a depositor and whether there are fees (how high?) that banks require to close an account**
[what are the fees associated? What are the fees for opening an account, minimum balances, fees for closing an account]

Answer

There are no mandatory fees for opening or closing an account and most banks today don't establish minimum balances. Banco Central do Brasil conducts monthly researches on the values of banking fees and this information is available for customers on the web site www.bcb.gov.br. Information from December/2004 show that banks charge no fees for closing accounts but a few of them may charge for opening an account - the highest value would be R$30,00 (approximately US$ 11) and the average value would be around R$ 13,96 (approximately US$ 5). Most banks also charge monthly fees for maintaining deposit accounts. When closing an account the client must present a written request to the bank branch where the account was opened. He also needs to return any checks that remain under his possession (if lost or stolen they must be cancelled). The client must also be informed the conditions required to close an account at the moment it was opened.

Question

5) **Is access of bank financing by the business sector based on:**
a) collateral guarantees (*i.e.* real estate)?
b) political patronage?
c) nature/size/length of time of existence of the firm?
d) accurate risk assessment of the project to be financed?

Answer

Access to bank financing by the business sector is based on the type and amount of collateral and other guarantees presented (real estate, vehicles, etc.), nature/size/length of time of existence of the firm and accurate risk assessment of the project to be financed. Regulation establishes that, when granting credit, financial institutions must properly analyze the credit risk involved in the operation and minimum provisioning rules must be observed.

Question

6) **What is the importance of the informal non institutional sector (families, friends etc.) for providing credit to the business sector, especially to smaller firms?**

Answer

Although the number of informal agents for providing credit or support for the business sector, especially for natural persons, is unknown, it is however a significant segment. There are approximately 17 million informal businessmen, which include those working on their own, as well as those that have up to 5 employees, with practically no access to the banking sector. Recent research done by the Development Ministry and the Caixa Econômica Federal (federal savings bank) estimates that, for a major part of the industry, there are more than 10 informal enterprises for each formal one established, which shows the increasing importance of this segment, which responds for more than half of the workplaces in our economy.

Therefore micro-credit has proven to be a type of credit adapted for natural persons that respond for productive activities, predominately informal. In Brazil, even though discussions and practices in this respect have shown advances in recent years, very little is known with respect to micro-credit. Even so, many government actions are being developed, seeking to expand this type of credit, especially by means of Organizações da Sociedade Civil de Interesse Público (public interest organizations of the civil society), micro-credit companies, development agencies and credit unions, to reduce the restraints relating to small scale businesses, utilizing alternative forms of collateral.

Question

7) **Does lender have access to customer credit report from reporting agency (Equifax, etc)? How transparent are business financial statements – e.g. bank more likely to lend to publicly traded company because more financial information is available? Does the regulator collect and provide to all banks an up to date register of all major debtors in the country (with a precise indication of the risk associated with each debtor), so that also a new entrant in banking can provide credit to local entrepreneurs? Is the information costly? Timely? Reliable? How do banks measure risk of borrower?**

Answer

Yes, the lender in Brazil has access to credit reports from agencies such as Equifax and Serasa (this last one is the biggest reporting agency from Brazil and it receives about 3 million daily consults). As stated in question 2, the regulator in Brazil collects information on the major debtors in the country and they are gathered at the Public Credit Register. Financial institutions may have access to some information contained at the Public Credit Register, if granted access by the borrower: they can see how much credit was granted to each borrower but they cannot see the name of the institutions and the rating assigned to the operations. This information can be accessed real-time through the Sisbacen (program used for communication between the Central Bank and financial institutions) or at the Central Bank. This information has low cost and financial institutions and the Central Bank make constant efforts to ensure the reliability of the information provided.
In Brazil it would not be possible to say that banks would more likely lend to public traded companies because there are not that many public traded companies in the country. There are about 661.753 companies listed at the Public Credit Register while there were only 359 companies traded at Bovespa, the largest Brazilian Stock Exchange.

Question

8) **In general do the official accounts of business firms provide a clear picture of their credit worthiness or do companies regularly have a double set of accounts (one for fiscal and one for company management purposes)?**

Answer

No, in Brazil a double set of accounts is not required. However, for fiscal purposes, adjustments in accounting must be made to calculate profits subject to taxation, etc. In general, the quality of Brazilian reporting standards can be classified as good and the official accounts do provide a fairly clear picture of their credit worthiness.

Question

9) **In the case of a non performing loan what are the options open to a bank (selling the collateral, suing the debtor, asking for government relief, etc.)? In the answer please provide some indication on the timing of each procedure and on the costs involved.**

Answer

In the case of a non performing loan, the main options for the bank would be to sell the collateral or to sue the debtor when a mortgage or lean on a vehicle is involved or where the collateral is nonexistent or insufficient. It is important to notice that some credits may contain guarantees, where a third person (called "guarantor" – may be a financial institution) takes responsibility for the payment of a debt or performance of some obligation should the primary borrower fail to perform.
In 2003 Banco Central do Brasil published a Technical Note[1] that explores issues associated to the judicial system and the credit market in Brazil. In Brazil the high spreads are usually associated to default rates, the quality of collateral and guarantees and the high costs of recovering credits through the judiciary.
According to the study previously mentioned, the cost of defaults represents 17% of the banking spreads. However, this is an average value and this number may present substantial changes according to the credit line under analysis. Auto loans and credits for exports (ACCs – "Adiantamentos de Crédito à Exportação") are among those with "high quality" guarantees.
In the case of auto loans, the process to recover the collateral (i.e. the vehicle financed) is relatively quick, at a low cost.
In the case of ACCs they are usually linked to high quality collateral: receivables from foreign companies, most of them presenting high credit risk ratings. There is also strict government control over these operations, making frauds extremely difficult. As a result, the default rates are very low (0,3% in 2002) as well as the spreads.
Research conducted by the Banco Central do Brasil in 2001 and included in the Technical Note shows that the majority of corporate credits contains some types of guarantees, while the opposite situation is experienced on personal loans:

Guarantees on credit operations - September 2001 (%)

Type	**Without Guarantees**	**Pledges and Guarantees**	**Motgages**	**Fiduciary guantees and others**
Corporate Loans				
ACC	29,7	13,3	0,3	56,7
Hot money	61,4	36,9	-	1,7
Working capital	38,0	24,0	7,4	30,6
Revolving lines	36,2	43,6	0,2	20,0
Vendor	3,2	89,0	0,1	7,7
Personal Loans				
auto loans	-	-	-	100,0
personal credit	71,9	19,0	-	9,1
habitation loans	-	-	97,6	2,4
overdrafts	85,8	12,2	-	2,0
credit cards	100,0	-	-	-

When it comes to suing the debtor, financial institutions face high costs related to the process itself and to the significant length of time until the question is ruled in court. The table below shows the

[1] FACHADA, Pedro; FIGUEIREDO, Luis Fernando; LUNDBERG Eduardo. *Sistema Judicial e Mercado de Crédito no Brasil.* In: Notas Técnicas do Banco Central do Brasil – Número 35 – Maio de 2003.

results of research conducted among financial institutions to infer the medium time needed to obtain possession of guarantees:

Time	**Mortgages**	**Pledges and guarantees**	**Fiducuary guarantees**	**Others**
Months	24	37	20	31

Recovery costs for loans below R$ 1.000 (approximately US$ 350) may be equal to or higher than the principal amount. For a credit of R$ 50.000 (approximately US$ 17.850) the recovery rate may be as little as 24,1% of the principal amount and it may take up to 5 years. Extra-judicial recoveries may be faster and present higher recovery rates (for the previous example: recovery may be as much as 83% in as little as one year).

Question

10) Do businesses in general have a credit relationship with only one bank or is the phenomenon of multi banks credit widespread?

Answer

Brazil's Public Credit Register, managed by the Banco Central do Brasil and where financial institutions provide a wide range of information on the quality and amounts of credit granted, contains information on the number of creditors per borrower within the financial system. Any credit which is above R$ 5.000 (approximately US$ 1.800) must be registered by the financial institutions. The table below, using data from September/2004 shows that most corporate and non-corporate clients have a credit relationship with only one bank (67,04% and 78,20% respectively). Therefore, it is not possible to say that the phenomenon of multi banks credit is widespread in Brazil.

	Type of customers	**Consumers**	**Corporates**
	Number of customers Registered at the PCR*	8.184.454	661.753
% of customers that have a relationship with 1, 2, 3, 4 or 5+ banks	**only 1 bank**	78,20%	67,04%
	2 banks	15,70%	19,27%
	3 banks	4,13%	7,18%
	4 banks	1,22%	3,11%
	5 or more	0,75%	3,40%

Question

11) **Please describe the institutional structure of banking regulation in your country. What body/agency is responsible for bank regulation? Is there more than one regulatory agency (such as a “Banking Commission”, or a “Financial Services Authority” - in some countries this role is played by the central bank)? To whom is/are it/they responsible or accountable (prime minister/finance minister/legislative body…)? What is the form of this institution, its principal functions and statutory objectives? How transparent is its decision making? Are its decisions published? What discretion does it have? How does it exercise that discretion? Etc.**

Answer

Law 4595/64 sets out the framework for Brazil’s national financial system, creating the Conselho Monetário Nacional (National Monetary Council - NMC) and the Banco Central do Brasil (BCB). By law, the NMC has the responsibility of regulating financial institutions, as well as determining penalties. The NMC is composed of three members: the Minister of Finance, who presides the council, the Minister of Planning and the President of the Central Bank, each having voting powers. Additional regulation and inspection procedures are the responsibility of the BCB.

Several agencies are responsible for the regulation and supervision of other types of financial entities, no single one being the leading supervisory agency. The responsibilities of other federal government supervisory agencies are the following:

Securities and Exchange Commission - CVM is responsible for the stock exchanges, commodities and future exchanges, the exchanges’ clearing systems, and investment funds. It also has shared responsibilities with the Central Bank in regards to the following entities: investment banks involved with the securities market, securities brokers, securities dealers and the placement of equity and bonds by other financial institutions;

Private Insurance Superintendence - SUSEP is responsible for open-end pension entities, insurance companies and brokers, capitalization companies and health insurance management companies;

Complementary Pension Secretariat - SPC of the Ministry of Social Security is responsible for private closed pension funds.

Brazil’s Banking Law (Lei 4.595/64) makes clear that the Banco Central do Brasil is responsible for both supervision and regulation of the banking and financial system, as an executive arm of the National Monetary Council, who defines the general policy and rules. The Banking Law (Lei 4.595/64) and the Securities Law (Lei 4.728/65) give powers to the NMC and BCB to define prudential standards for banks and other financial institutions. Financial system regulations are updated as frequently as necessary by Resolutions of the NMC and complementary regulation (Circulars) issued by the Board of Directors of the BCB.

BCB is a semi-autonomous agency with its own separate legal identity, being hierarchically subordinated to the Ministry of Finance. There is no significant evidence of government or industry interference in the operational decision-making of the agency. The President of BCB and the members of the Board of Directors are appointed by the President of the Republic, after public scrutiny and approval by the Senate, and do not have a specified term of office.

The NMC and the BCB are empowered by law to set prudential rules administratively. Legislation in force enables the BCB to inspect financial institutions; apply penalties; authorize operations and issue licenses; require remedial action of problem institutions (such as capital requirements, mergers and splitting, transfer of stock control, etc) and revoke licenses (closing out of the banking institution).

The BCB is constantly seeking improvements in transparency standards. All relevant regulation and information are made available to the public at the BCB’s website on the Internet (such as the supervisor’s manual). In some cases the BCB puts more relevant draft regulation up for public audience, giving the opportunity for markets and society in general to make comments before the final issuance of the new regulation.

There are two additional laws of importance regarding financial markets: Law 7.492/86, that deals with financial crimes, and Law 9.613/98, regulating the prevention of crimes stemming from money laundering. Law 6.385/76 created the CVM and regulated the securities market.

Sector-specific regulation in banking: Structural regulation

Question

12) Can you describe the rules on branching and new entry in your country?

Answer

The rules for entry in the national financial system are set out in Resolution 3040, issued in 2002 by the National Monetary Council. These regulations establish that the entrance of a new financial institution must meet a series of requirements, in a two-stage process, in regards to the initial set-up of the institution and effective authorization to operate. During the set-up stage, information, studies and projects outlining the institution during the initial years of operation are submitted for prior approval. Prior biographical and financial history of all organizers, senior managers and principal stockholders is also examined.

Should there be no objections to the request, the BCB informs the interested parties that the data furnished by the organizers of the new institution is satisfactory. They must then adopt formal measures necessary to effectively set-up the institution, which includes approval of the by-laws, the election of senior management, as well as the subscription and integration of initial capital. These acts must form part of the petition for the authorization to operate and may only be presented for public registration after approval by the BCB's.

Those that form part of the controlling group of the financial institution must be clearly identified during the approval process and must be included in a declaration of proposal, which must be published in the major newspapers where offices are to be set up. Only natural persons, financial institutions or holding companies formed to hold shares of financial institutions may hold the controlling interests of a financial institution. The declaration of proposal has the goal of giving ample publicity of the pretensions of the controlling party and permit that eventual objections be informed to the Banco Central do Brasil.

Those interested in forming a new institution must present an economic-financial viability study, business plan and information regarding adherence to corporate governance principles that must cover at least the first three years of activity. The viability study must contain, at the minimum:

analysis of the market segments in the region in which the institution will operate and the expectations for market growth, as well as major competitors in each segment;

expectations for income, indicating expected returns in each of the market segments chosen;

financial projections showing the evolution of net worth in the period, and indicating the source of funds that make the predictions viable.

The business plan must cover, at the minimum:

a) details of the proposed organizational structure, with a clear definition of the responsibilities placed on the different levels of the institution;
b) specification of the internal controls structure, making evident the mechanisms that guarantee adequate supervision by the administrative sector and the effective utilization of internal and external auditing as a control instrument;
c) establishment of strategic objectives;
d) definition of the principal products and services and targeted public;
e) technologies to be used in placing products and services and proper dimensioning of the network;
f) definition of the time limit to initiate activities after having received authorization to operate;

g) description of criteria utilized to chose senior managers.

In regards to corporate governance, standards that the institution will observe should be defined, including the details of the incentive structures and remuneration policies. The documentation presented is analyzed by the Banco Central do Brasil, taking into account the size and nature of the institution. During the first three years in operation, the predictions and other information furnished at the outset will be utilized as instruments to verify convergence between the projections presented and effective practice.

The evaluation of the economic-financial capacity of the controllers is related to the dimension and profile of the risk associated with the project, as well as prior experience and the level of compromise of the controlling stockholders.

The opening of branch offices in Brazil by a financial institution requires that the regulations set down in annex III of Resolution 2099, of 1994, be observed, which require that legal formalities, as well as minimum capital requirements and other operational limits, be met, and that bank inspectors have presented no objection to the measure.

Question

13) **Is the entry of foreign banks specifically regulated? Are there restrictions to their operations in your country, both in terms of market size and of services offered? Once foreign banks have entered the domestic market, are they subject to rules different than those applying to national banks?**

Answer

In regards to foreign capital in the national financial system, and until conditions foreseen in art. 192 of the Constitution have been established, new authorizations for the operation of financial institutions controlled by or having any participation of foreign capital require a decree issued by the President of the Republic, granted on a case-by-case basis.

Based on directives presented by the Minister of Finance and approved by the President of the Republic, the Banco Central do Brasil may analyze petitions for foreign participation in financial institutions and, if approved, submit them to the National Monetary Council for deliberation before final decision by the President. By means of Communication 10844, the Banco Central do Brasil issued basic orientation for foreigners interested in obtaining a license to operate as a financial institution in the local markets, and once authorized must abide by the same regulations and conditions set down for domestic entities, that is, subject to national treatment.

Question

14) **In the case of financial investments into a bank capital (by other banks or by non banks) are the principles of safety and prudence exactly defined (either by the law or by the regulator) so that an investor can anticipate the likely response? How much discretion does the regulator have? How has it been used?**

Answer

Yes, all the principles of safety and prudence regarding risk management, minimum capital requirements, risk weighted capital, consolidation rules and others are established in regulation and may be accessed by the public. Regulation in force (Resolutions 3.040 and 3.041) also states which conditions agents (banks or non banks) must observe if planning to control a financial institution (the authorization is subject to previous authorization by the BCB). The regulator must approve the acquisition and the following aspects are analyzed: technical expertise to manage a financial institution, financial and economic capacity of the controller, and demonstration of the origin of the financial resources used in the acquisition, among others. If one or more criteria are not met, the regulator may deny the authorization requested.

Also, for foreign participations, there is a Constitutional requirement, already mentioned, for Presidential agreement for the entry of foreign financial institutions/investors in the national financial system or an increase of already existent participation. In the process, the BCB consults with foreign supervisory authorities for their agreement or no objection statement.

Question

15) Is the expansion of banks regulated? Are there explicit limits to its geographical concentration? Is there regulatory supervision on the opening of new branches?

Answer

There are no limits for the expansion or the geographical concentration of banks. However, Resolution 2.099 establishes lower levels of minimum capital that should be held by financial institutions with branches or headquartered outside the main financial centers (Rio de Janeiro and São Paulo). According to regulation, for example, commercial and multiple banks operating in Brazil must observe a minimum capital requirement of R$ 17,5 million (approximately US$ 6,3 million). If the institution has its headquarters and 90% of its branches outside the states of Rio and São Paulo, there is a 30% reduction on this requirement. This R$ 17,5 million requirement allows authorization for the opening of up to 10 branches. Each additional branch requires an increase of 2% over the original minimum capital – this increase is of 1% if the branch is located outside the states of Rio de Janeiro and São Paulo.

Sector-specific regulation in banking: Behavioral regulation

Question

16) Are there regulatory restrictions on pricing (interest rate controls and other control on prices and fees)? How are they administered? Are there restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements not to hold other securities; including requirements not to hold the control of non financial companies)?

Answer

Currently there are no restrictions on pricing, but the banks must make public the value of the fees charged and before any increases the customers must be previously informed. Regulation also establishes the basis and indexes that may be used for the remuneration of assets and liabilities (for example, repo operations).

Regarding restrictions on the portfolio of assets that banks can hold, the following comments should be made in regards to directed credit:

(a) 65% of savings deposits must be directed for housing finance. 80% of this amount must be granted to SFH operations (mortgages) with maximum interest rates of TR + 12% p.a. The “TR” is the basic remuneration (floating rate), calculated on interest paid on CDs, for the savings deposits, which earn TR + 0,5% p.m.;

(b) 25% of demand deposits must be directed for rural finance at an annual rate of 8,75%;

(c) Foreign exchange exposures are limited to 50% of the PR (tier 1 + tier 2 capital);

There is an immobilization limit – investments in fixed assets are limited to 50% of the PR;

Credit and financial leasing operations to the public sector are limited to 45% of the PR (there are exceptions for Treasury bonds and credits with guarantees from the Treasury – this rule is mainly applicable to credits to states and municipalities);

2% of demand deposits must be directed for microfinance.

Question

17) Are there requirements to direct credit to favored sectors and enterprises?

Answer

The Brazilian government has taken actions over the last 2 years in order to widen the access of small enterprises and entrepreneurs to credit – many of these actions have taken place at the micro credit segment and on incentives to the development and expansion of Credit Unions. The requirements to direct credit for microfinance are contained in Resolutions 3109 and 3112, that require that 2% of demand deposits be directed to micro finance operations. The credit granted must be no higher than R$ 1.000 (approximately US$ 357) and the maximum effective interest rate is 2% per month, with an up-front fee not to exceed 2%, for natural persons, and 4%, for legal persons. Finally, the minimum maturity for these operations is 120 days. If the 2% limit on demand deposits is not met, the financial institution must maintain the difference at the Central Bank as a compulsory deposit.

Question

18) Besides the formal statutory regime, are there any understandings or expectations about the actions of, say, the central bank (such as "lender of last resort" or "too big to fail") or other government agencies which could affect the behaviour of banks?

Answer

Even though in the recent past the BCB helped banks facing difficulties, especially during the 1999 currency devaluation, the understanding today is that those were special cases (the government created two programs to help institutions facing problems – "Proer", for private financial institutions and "Proes", for public financial institutions – in a scenario where the economy was facing a moment of instability. The BCB does have a discount window for liquidity reasons. Given the present conditions of the economy, the fiscal adjustment process and the actions taken by the BCB in most recent cases of financial institutions liquidation, the system should not rely on a "too big to fail" premises.

Competition Regulation in banking

Question

19) Please describe the application of the national competition law to the banking sector. Are there any exemptions to the application of the national competition law that apply to banks? Are banks subject to the general competition law or to specific competition rules (i.e., are there special provisions relating to bank mergers, inter-bank agreements, and so on)? If the latter is the case, are these sector-specific competition rules more restrictive or less restrictive than the national competition laws? What was the public policy reason behind sector-specific competition rules?

Question

20) Who enforces the competition laws in the banking sector? Is it the sole responsibility of the national competition authority? If not, is the responsibility shared with another agency, or solely the responsibility of another agency? Does this other

agency also deal with prudential regulation? If the responsibility is shared, how is it shared? (i.e., are some components of competition law, such as horizontal agreements, the responsibility of one agency and other components, such as the regulation of mergers, the responsibility of another?) Does one agency have a veto over another, or consensus is required? If another agency has sole responsibility for all or part of the competition laws in the banking sector, does the national competition authority have the right to provide advice? Has it ever done so? How was it valued by the regulatory agency? Please comment on the decisions taken by this other agency, from a competition perspective.

Question

21) Please comment on particular actions taken by the competition authority:

(a) In the case of mergers, what has been the approach of the competition authority to market definition? Which separate markets were identified, why? Have you treated banks as offering a bundle of services to each customer or as offering a multi-product range, with different markets for each product? What was the geographic scope of each market? Has the Internet or telephone banking appreciably affected questions of market definition? Was the informal sector considered in the antitrust analysis of bank behavior?

(b) In the case of horizontal arrangements, have you found that features of the banking industry facilitate collusive arrangements? Have network effects and/or inter-bank agreements relating to, say, ATMs, electronic processing of transactions, payment systems or joint marketing of credit/debit cards raised competition concerns? Have concerns been raised about bank collusion in the wholesale markets, such as the market for government debt?
Have there been specific instances of abuse of dominance or vertical arrangements which have raised competition concerns? For example have there been instances by dominant companies requiring customers to purchase a product in order to get product customer wants?

Question

22) Are there any other particular issues or experiences in the enforcement of competition law that you think would be of interest to other competition authorities? If so, please describe them briefly and, where relevant, provide citations to any relevant publications.

Question

23) Have there been any important regulatory changes (relating to any of the components of the regulatory regime discussed in the previous paragraphs) in the past two years? If so, briefly describe the situation before the change and the main effects of the change.

Answer

This answer covers all questions above. Competition issues within the economy are dealt with by the Conselho Administrativo de Defesa Econômica (Economic Defense Administrative Council), along with secretariats within the Ministry of Finance and the Ministry of Justice. Where financial institutions are involved, this issue is dealt with by the Banco Central do Brasil, in accordance with

the Banking Law and the Constitution. Draft legislation in Congress, drawn up by the Executive Branch as a consensus between all parties involved, will, if approved, transfer those cases that do not represent excess risks for the system to the aforementioned council for its prior approval.
When examining acts that could present questions relating to concentration, the BCB has adopted a posture which privileges the safety and strengthening of the financial system, adopting criteria internationally accepted, that primarily seeks to prevent systemic risk which could compromise the system as a whole, as well as other segments of the economy. Even though the anti-trust authority and the BCB work independently in monitoring competition in their respective areas, the two entities maintain an open channel for exchanging information and for technical cooperation.

Banking, competition and economic development – HUNGARY

Introduction to the answers

As a result of the development since 1987, the year in which it became a two-tier banking system, the banking system of Hungary, a member of the group of transition economies, has had the same characteristics as its Western European counterparts. It is a universal banking system.

During the last years, the Hungarian banking system was characterised by an overall quick growth, with an increasing level of the quality of its services and with improving performance. The intensity of financial transmission in comparison to the size (the total proceeds) of the economy became higher while the transmitted capital stock remained small in an international outlook in proportion to the GDP, i. e. some 70% as against an average of 260% for the EU.

There are 30, mostly universally active commercial banks, 3 mortgage banks and 2 savings banks (for housing finance) on the Hungarian market of banking. A list of them has been enclosed. As far as the ownership structure of the section is concerned, foreign ownership amounting to approximately 82% prevails. The majority of the owners are banks resident in EU Member States though there are some others of them are from America and Asia, too. After Hungary's accession to the EU, almost fifty financial institutions notified to the Hungarian supervision, utilizing the possibilities given to them by the Single Market (the uniform European passport), their intention to provide cross-border services. The effects or at all: the commencement of such service providing activities were nevertheless not perceptible in the year 2004.

There is a medium extent of concentration in the sector, with 75% (taking also into consideration the mortgage-banks: 81%) of the assets belonging to 10 large banks and 56% and 62% of the assets to the 5 largest of them or them and their subsidiaries respectively.

QUESTIONS

Role of banking in financing business activity in your country

Question

1) Besides the traditional deposit-taking and credit-offering functions, what additional services are provided by banks in your country:

Services for depositors like:

- **Credit cards services, paying bills for depositors**
- **Consumer loans [auto, personal, bill paying, etc]**
- **Mortgages**
- **Life insurance**
- **Financial advisors; Management of investment funds; Asset management**

Services for firms like:

- **Banking services for firms (business liquidity loans, capital investment loans)**
- **Brokerage services**
- **Corporate banking services**
- **Investment banking (Stock Exchange listing, trading, clearing and settlement services)**

Answer

The Hungarian banks provide a large scale of financial services, all but life insurance out of the services listed in the questionnaire. The reason for that is a provision in the Hungarian law according to which exclusively insurance companies may be entitled to act as insurer. In their capacity as intermediaries also banks offer, however, insurance products. Investment fund management is performed by specialized trust companies rather than by banks. It happens on the market of both the companies acting as insurers and companies performing investment fund management that some of them belong to the group of one of the banks.

Each of the 30 banks acting on the banking market collects deposits, offers credits both in the retail and corporate segments, though the weight of these activities is different. There are 19 and 5 banks present on the market of bankcard issuance and acceptance respectively. 89% of the cards issued are debit cards whereas the other 11% of them are credit and charge cards. On the market of bankcards co-branded cards account for a share of 10%. Apart from the banks thrifts (about 170 by number) are also active on the market of deposit-taking, credit-offering and bankcard services their weight is however, in comparison to that of the banks, not significant (their share is, based on the balance sheets, approximately 6%) and their activities are typically limited to regional markets.

Many of the banks offer mortgage-based credits but only three of them are specialized in mortgage lending and mortgage bond issuance on the Hungarian market.

Stock exchange security dealings and security dealings on the OTC market are not performed by each of the banks. Sixteen of the banks or their subsidiaries are floor members.

Question

2) **With respect to the list of financial services contained in 1) are there regulatory limitations that constrain the ability of banks to offer some of them? Are there regulatory limits on the ability of banks to lend?**

Answer

The foundation of banks and their professional activities (i. e. their general and specialized activities on the banking markets and capital markets) are regulated by statutes. These statutes subject the performance of the activities to certain minimum capital requirements (which are the same as the related requirements provided for by the directives of the EU) or to an authorization of the state professional supervision (the Hungarian Financial Supervisory Authority). The authorization is subject to the fulfilment of, in addition to the capital requirements, professional and objective preconditions. The activities, which may be performed, are established in the operating licence. The Act, which regulates the activities of the banks, provides rules for the acceptance of risks, restricts the acceptance of the so-called "aggravated" (i. e. aggravated in comparison to the guarantee capital) risks and lays down the rules for risk management and the accumulation of reserves.

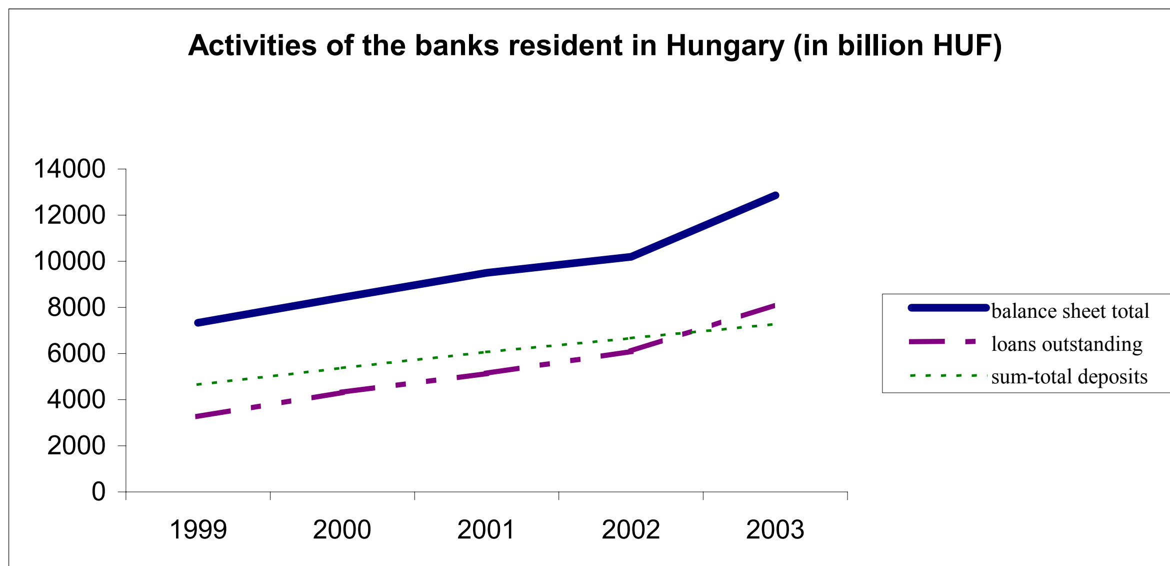
Question

3) **Considering each service as detailed in question 1), please provide a brief description of the market structure, considering that for most of these services banks compete also with non banks and that if the size of the market is local you should provide some sort of nation-wide averages:**

Answer

As a consequence of the mergers implemented on the market during the last years, the number of the Hungarian banks was gradually decreasing while their activities were progressively extended. The diagram below illustrates the increase of the balance sheet total, of the loans placed and the deposits collected.

The retail loans of the banking sector increased dynamically, they doubled during the last three years. The share of housing loans within retail loans went up from 58% to 69% and their volume increased by almost 150%. Consumer loans (i.e. consumer finance of car purchases, other loans to private persons, discretionary mortgage credits, commodity credits, credits connected with credit cards or bank accounts) and other loans increased to a slower extent, by 52%.



Question

(d) is there a single provider for each product? Are there a few large providers? Are there many providers?

Answer

On the market of corporate loans 70% of the loans outstanding belong to 6 banks, the highest market share being about 15% with no significant difference between the largest share and the next ones. Similar situation exists on the market of corporate deposits. There are large, medium-, small- and micro-size firms on the corporate banking market.

On the contrary, the market of retail loans is far more concentrated. One of the banks accounts for some 40% of the loans outstanding, while the market shares of the next ones remain under 10% each. About 70% of this market belongs to 5 banks. On the retail deposits market 3 banks have got more than 70% of the sum-total deposits with the market share of the largest of them being one magnitude higher than that of the next one. A similar situation exists on the market of retail account management. Consequently, the markets of retail banking services are more concentrated, while those of the corporate services are more balanced.

There are 3 providers on the market of mortgage bonds with a market share of 65%, 30% and 5% respectively.

Question

(e) Is there one single consumer of the product considered? Are there a few large entities as major consumers? Are there many consumers?

Answer

Question

(f) In geographic terms, how wide is the market for the products concerned?

[are customers' branch/location dependent? What is the willingness of customer to use distant branches?]

Answer

The geographic market of the banking sector is countrywide in size, as the majority of the banks have a countrywide branch network through which they offer their services on uniform terms and conditions. In addition, electronic banking services are gaining ground step by step, to date mostly in the corporate segment. Post offices, which are active in almost all localities, become more and more involved as intermediaries of retail services, which offer the services of some of the banks. As a poll suggests retail customers tend to choose their bank within a radius of up to 50 km as a maximum.

Question

4) Please briefly describe the paperwork required to switch bank for a depositor and whether there are fees (how high?) that banks require to close an account
[what are the fees associated? What are the fees for opening an account, minimum balances, fees for closing an account]

Answer

At switching from one bank to another, a new bank account agreement put in writing must be concluded which typically needs a branch office of a bank to be visited though occasionally it can be arranged by mail. No fees for the closing of the existing accounts are charged, only the bank costs, which are due in connection with the account management, are to be paid. Should fixed deposits be on the account, the possible break of the term results in loss of interest.
There is no extra cost for the opening of a new account; it may however happen that a mandatory minimum balance requirement relating to the new account must be satisfied. The use and extent of such a requirement is different from bank to bank.
The paperwork to be done by the customer that is part of the account closing and opening is different from bank to bank. At some banks this belongs to the job of the employees of the bank who immediately register the data needed in their computers and print the contract to be signed.
As experience has showed retail customers in Hungary are typically not busy at all in switching over to a new bank.

Question

5) Is access of bank financing by the business sector based on:
a) collateral guarantees (*i.e.* real estate)?
b) political patronage?
c) nature/size/length of time of existence of the firm?
d) accurate risk assessment of the project to be financed?

Answer

Banks assess, of course, also in respect of credits offered in corporate business the credit worthiness of the applicants, the risks of the targets to which credits are tied, which latter may be influenced by the nature and size of the applicant, the length of the period of its operation, its performance and possible debts. This means there are mainly business aspects that will be taken into consideration. Banks assess whether the corporate plans, which are connected to the targets are well founded; the bank knowing the applicant in question also affects its credit worthiness. This is the explanation for the fact that banks prefer to give credit to firms with an account managed by the given bank as in such cases the bank has a view of the operation and incomes of the firm concerned. Foreign-owned banks also take into consideration in respect of firms, about which there are references available at their respective parent banks, those references.

Question

6) **What is the importance of the informal non institutional sector (families, friends etc.) for providing credit to the business sector, especially to smaller firms?**

Answer

In recent years the issue of giving credits to small proprietorships came more and more into the limelight. The loans outstanding given to them grew at a higher rate and to a higher extent within the banking sector in comparison to the credits given to large firms. (As shown by data from the year 2003, the loans outstanding of the sector of small entrepreneurs increased at an annual rate of 29% as against 18.4% for the large firms.) Almost 60% of the loans to SMEs were given by 4 banks with a higher than 10% market share each; there were altogether 10 banks on this market the market share of which exceeded 2%. Within the financing of firms, in particular large firms borrowing abroad played a significantly greater and greater role.

Question

7) **Does lender have access to customer credit report from reporting agency (Equifax, etc)? How transparent are business financial statements – e.g. bank more likely to lend to publicly traded company because more financial information is available? Does the regulator collect and provide to all banks an up to date register of all major debtors in the country (with a precise indication of the risk associated with each debtor), so that also a new entrant in banking can provide credit to local entrepreneurs? Is the information costly? Timely? Reliable? How do banks measure risk of borrower?**

Answer

In compliance with the provisions of the Act regulating the operation of credit institutions, a central credit information system (Interbank Informatics Service Provider Co Ltd), which has been approved by the Hungarian Financial Supervisory Authority, is operating in Hungary. According to the Act, credit institutions are obliged to join the system. They forward data as provided for by the Act, in the frame of cooperation agreements they concluded with the credit information system, to the database and information contained in the database is available to them. The database of the Interbank Debtors' Information System (operated by the Interbank Informatics Service Provider) covers all the data the central registration of which is prescribed or allowed by statutes and which are provided by the users of the system about their clients. The statutory obligation of joining to the system and the Cooperation Agreement relating to the use of the Information System are guarantees of the database containing always complete, exact and updated information. Every user enjoy the same rights at having queries about these data.

The entrepreneurial system stores the data, covered by the Information System, about entrepreneur-clients of the financial institutions in the following three subsystems: credit contracts, insolvent firms, terminated contracts relating to the acceptance of cash replacing means of payment.

The retail system stores the data of all natural persons who committed, in a way established by the Act, a breach of the credit contract or the like or the contract about the use of cash replacing means of payment he/she concluded with financial institutions. The retail system has two subsystems, namely those keeping records about credit-related failures and bankcard-frauds respectively. Both subsystems contain negative lists covering clients only after they committed a breach of contract.

Question

8) In general do the official accounts of business firms provide a clear picture of their credit worthiness or do companies regularly have a double set of accounts (one for fiscal and one for company management purposes)?

Answer

To assess the credit worthiness of a corporate client, the fact in itself it has an account managed by a given bank is not enough, for it may has accounts managed by different banks. Though at assessing a credit demand, the account-managing bank also takes into consideration its knowledge received from its business contacts with the client in question but in addition, it asks for the books (balance sheet, extracts from the books of account) of the applicant to be submitted in any case so that it can check the performance of the operation, it scrutinizes the corporate plans, which are connected to the targets and, occasionally, it carries out on-spot information gathering too.

Question

9) In the case of a non performing loan what are the options open to a bank (selling the collateral, suing the debtor, asking for government relief, etc.)? In the answer please provide some indication on the timing of each procedure and on the costs involved.

Answer

As a matter of course, credit contracts concluded with debtors, the connected contractual conditions and the general terms and conditions of contract of the banks foresee sanctions for the case of non-payment. Such sanctions are a. o. the imposition of interest on arrears and, as a last resort, the filing of a suit against the debtor. Banks may stipulate they may charge, in the case of non-payment, any account of the non-paying client managed by it, including fixed deposits at maturity or may submit an immediate order for collection against any account of the non-paying client managed by another credit institution. It may require the provision of a collateral (e.g. an asset that must be insured by a cover against all risks, assigned for the benefit of the bank), which is suitable to settle all claims of the bank should the debtor not pay. The bank may stipulate the notarization of the credit contract and the connected collaterals that may facilitate and hasten a possible execution..

No information about the costs and expenditure of time of the measures banks may take for the case of non-payment has been available but as far as their time-consumption is concerned, it may vary between a few weeks and several months.

Question

10) Do businesses in general have a credit relationship with only one bank or is the phenomenon of multi banks credit widespread?

Answer

As it was mentioned under point 9) above, firms may have operational accounts at more than one bank. The register court is keeping a record of the numbers of the firms' operational accounts, hence the certificates of incorporation show the banks at which firms have operational accounts managed. It is an established practice that account-managing banks act as creditors of their clients as the knowledge they receive during their business connections facilitate them to assess credit worthiness.

Question

11) Please describe the institutional structure of banking regulation in your country. What body/agency is responsible for bank regulation? Is there more than one regulatory agency (such as a "Banking Commission", or a "Financial Services Authority" - in some countries this role is played by the central bank)? To whom is/are it/they responsible or accountable (prime minister/finance minister/legislative body…)? What is the form of this institution, its principal functions and statutory objectives? How transparent is its decision making? Are its decisions published? What discretion does it have? How does it exercise that discretion? Etc.

Answer

The foundation and the operation of banks are regulated by Act CXII of 1996 on Credit Institutions and Financial Services Companies. The Act lists, a. o., the services banks are obliged or entitled to provide, lays down, in respect of both form and content, the requirements (i. e. capital-related requirements, subjective and objective preconditions) to be fulfilled for the authorization of the foundation or the operation, lays down organisational rules and nominates the institution (the Hungarian Financial Supervisory Authority) vested with state supervisory and authorization powers. Some activities determined by the Act (as currency exchange, money processing activities) need an authorization of the National Bank of Hungary to be pursued. Capital market activities are regulated by a separate Act. There are statutes that set out the requirements for the operation to be prudent and the liquidity to be secured, limit risk-taking, lay down supervisory powers and contain provisions relating to insurance (deposit protection and investor protection) and to the protection of institutions and rules for the dissolution of the latter. The regulations contained by these statues are compatible with their EU-counterparts.
The Act on the Financial Institutions and Financial Services Companies authorizes the Government and the Minister of Finance to adopt decrees the subject of which is determined by the Act. (Such decrees may relate e.g. to the provision of certain services, the establishment of calculations of interests on deposits and the distribution of the results of those calculations, the establishment of calculations of the annual percentage rate of charge on credits and the distribution of the results of those calculations and the assessment of receivables.)
As mentioned above, it is the Hungarian Financial Supervisory Authority, which is responsible for the supervision of the operation of banks. It is under the governance of the Government and the supervision of the Minister of Finance. Its powers are set out in the Act on the Financial Institutions and Financial Services Companies, in its work it cooperates with the National Bank of Hungary.
Based on the authorization given to it by the Act, it is the Supervisory Authority that, a. o., assesses applications and other submissions, keeps registers as it is prescribed by the Act, controls the information system of the financial institutions and their data-supply, makes checks and investigations about how the rules governing the provision of financial and ancillary financial services are observed, examines, analyses and assesses prudent operation of the financial institutions and secure handling of the deposits and the other resources to be repaid and, furthermore, the conditions that endanger expert management, control and leading. It takes measures to eliminate the irregularities observed, adopts exceptional measures to eliminate harmful malpractices and imposes fines against discovered infringements. Should unsettled questions arise, it decides about whether an activity at issue qualifies as the provision of a financial or an ancillary financial service under the Act. It cooperates with foreign authorities, in particular with those performing supervisory duties within Member States of the European Union. Due to the "single passport", the importance of this cooperation has strongly increased since Hungary's accession to the EU on 1 May 2004 and also its content is changing.
The authorizations granted by the Supervisory Authority may determine the time until which they have effect, may be subjected to conditions or may contain limitations in respect of the field of

activity, the geographic area or (concerning the provision of financial services) the business or the product-range.
The Supervisory Authority publishes the decisions reached by it in an official gazette and on its web site.
As a result of legal provisions, to decide in certain aspects as setting time limits, making conditions or imposing fines is left to the discretion of the Supervisory Authority the decision making of which is transparent.

Sector-specific regulation in banking: Structural regulation

Question

12) Can you describe the rules on branching and new entry in your country?

Answer

The foundation and the commencement of the operation of credits institutions or of credit institutions functioning as branch offices need, according to the Act on the Financial Institutions and Financial Services Companies, an authorization of the Supervisory Authority, except for, as of May 2004, branch offices of credit institutions with a seat in another Member State of the European Union.
To be enclosed to an application for authorization of the operation of a credit institution are, a. o., the corporate charter containing a clear indication of the field of activities; a document indicating the planned territory of the operation (countrywide or limited to a certain area); an acknowledgement of payment by the founders and availability of 50% of the HUF 2 billion (equal to approximately Euro 8 million) subscribed capital prescribed by the Act, a draft about the organisational structure, the management, decision making and control system and the statutes of the institution for the case these latter are not contained in details in the corporate charter. In the case of the foundation of a financial institution functioning as a branch office the corporate charter of the foreign financial institution; an original certificate not older than three months of incorporation of the foreign financial institution or an acknowledgement of the foreign financial institution having been registered in the corporate (economic) register; a copy of the authorization of the operation issued by the supervisory authority responsible by the seat of the foreign financial institution; a confirmation of the fact that the foreign financial institutions parties to the foundation are not debtors of the tax authority, customs authorities and social insurance organs in Hungary and the State of their residence; an indication of the activities of the applicant, and of the places where these activities are carried out, authorized by the supervisory authority responsible by the applicant's seat must be attached too. The Supervisory Authority authorizes the foundation of financial institutions functioning as branch offices where – supposed the conditions set out by statutes are met – there is a cooperation agreement in force, based on the mutual recognition of the supervisory authorities, also covering the supervision of branch offices, between the Hungarian Financial Supervisory Authority and the supervisory authority responsible by the seat of the financial institution submitting the application; the State of residence of the financial institution submitting the application has legal provisions adequate to those in Hungary against money laundering; the financial institution submitting the application has data management rules complying with the requirements made by the Hungarian legal norms; the financial institution submitting the application declares its willingness to unlimitedly acknowledge claims which arise under the name of the branch office; the financial institution submitting the application submits the authorization of, or the statement of assent to/acceptance of, the foundation of the branch office granted by the supervisory authority responsible by its seat; and the legal norms of the State of residence of the financial institution submitting the application ensure the prudent and safe operation of financial institutions.

After an authorization of the foundation has been given, there is a need to apply also for the authorization of the operation.

Question

13) Is the entry of foreign banks specifically regulated? Are there restrictions to their operations in your country, both in terms of market size and of services offered? Once foreign banks have entered the domestic market, are they subject to rules different than those applying to national banks?

Answer

The rules for the foundation and operation of financial institutions do not differentiate at all between domestic and foreign new entrants, hence no limitations relating to the size of the targeted market and the services offered exist. It has been for a decade that the related requirements are governed by the principle of equal treatment in respect of both their content and the procedure.

Question

14) In the case of financial investments into a bank capital (by other banks or by non banks) are the principles of safety and prudence exactly defined (either by the law or by the regulator) so that an investor can anticipate the likely response? How much discretion does the regulator have? How has it been used?

Answer

According to a statutory provision, influencing interest in a financial institution may only be acquired (based on an authorization of the Supervisory Authority) by persons, which are independent from any influence that would endanger the prudent operation of the financial institution, are able to ensure the reliable and careful management and control of the bank, have transparent business connections and a transparent ownership structure, consequently they do not preclude the exercising of an efficient supervision over the bank.

The Supervisory Authority refuses to grant the authorization if the criteria above are not satisfied, or the financial and economic situation of the applicant, taking into consideration the size of the acquision that is subject of the offer, cannot be seen as satisfactory, or the lawful origin of the means that were used to the acquisition of interest or the authenticity of the particulars of the person that has been indicated as the owner of those means cannot be proved, or the Supervisory Authority suspended, during a five-year period before the announcement, the exercising of the voting rights of the latter; or because it takes, in respect of natural persons, past events (e. g. criminal proceedings) into consideration.

Apart from the Hungarian State, other credit institutions, the Hungarian Post, insurance companies, investment companies, financial holding companies and the National Deposit Insurance Fund, none of the other owners may have an ownership stake exceeding 15% of the subscribed capital and a voting right higher than this extent.

Question

15) Is the expansion of banks regulated? Are there explicit limits to its geographical concentration? Is there regulatory supervision on the opening of new branches?

Answer

No regulatory limits have been made to the geographical expansion of functioning banks. The number and place of the branch offices banks wish to open depend on the business policy and cost-paying capacity of them.

Question

16) Are there regulatory restrictions on pricing (interest rate controls and other control on prices and fees)? How are they administered? Are there restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements not to hold other securities; including requirements not to hold the control of non financial companies)?

Answer

There is no state price- or cost-regulation in the banking sector. Banks set their prices (interests, commissions and fees) and choose what kind of prices and to what extent they use in compliance with their respective business policy, market position and the shares they wish to attain. The terms and conditions of the banks must be displayed, according to the provision of the Act, in the branches, 15 days at the latest before they come into effect; in general, the updated conditions can be seen on Internet websites, too. In consequence, banks can easily get to know the prices of each other.

It is a statutory provision that banks may not acquire or hold ownership stakes (as a result of direct and indirect investments) in other firms, that would exceed, counted in net values, 15% of their respective guarantee capital, with the exception of other financial institutions, investment companies, commodity exchange service providers, the organisation assuming clearing house activities under the Act on the Capital Markets, investment fund managers, the stock exchange, insurance companies, reinsurance companies and companies pursuing ancillary activities.

Similarly, they may not acquire or hold (direct plus indirect) ownership stakes in other firms, that would exceed, counted in net values, 51% of the subscribed capital of those firms, with the exception of other financial institutions, investment companies, commodity exchange service providers, the organisation assuming clearing house activities under the Act on the Capital Markets, investment fund managers, the stock exchange, insurance companies, reinsurance companies and companies pursuing ancillary activities.

Similarly, they may not have influencing interests in other firms, the sum of which would exceed, counted in net values, 60% of their respective guarantee capital, with the exception of other financial institutions, investment companies, commodity exchange service providers, the organisation assuming clearing house activities under the Act on the Capital Markets, investment fund managers, the stock exchange, insurance companies, reinsurance companies and companies pursuing ancillary activities.

At the three limitations above, not to be taken into consideration are ownership stakes, which are separately registered and managed, regularly assessed and came only temporarily, for a period of three years at the longest, counted from the date of their acquisition, into the possession of a credit institution for the purposes of reducing lost that result from financial services or as a consequence of a counter purchase of credits against ownership stakes or of a dissolution. Furthermore, not to be taken into consideration are ownership stakes registered in commercial records on share trading. Credit institutions are allowed to exceed these thresholds if they are, taken into consideration a reduced (i. e. reduced by the sum of the extras) guarantee capital, still able to satisfy the requirement to have a solvency rate of 8% and other, guarantee capital-related limiting requirements.

Question

17) Are there requirements to direct credit to favored sectors and enterprises?

Answer

In special cases banks may favour certain sectors or firms in their lending business. It may happen States wish to support in the frame of its economic policy some of the sectors or, for instance, the market entry or market activities of small- and medium-sized enterprises by subsidized credit interests and, based on a competition, delegates the task of credit placing to banks. There are favoured sectors of such targeted projects (e.g. launching credit) but banks give credits even in these cases only to creditworthy firms.

Question

18) Besides the formal statutory regime, are there any understandings or expectations about the actions of, say, the central bank (such as "lender of last resort" or "too big to fail") or other government agencies which could affect the behaviour of banks?

Answer

It has been for 10 years that the banking system of Hungary can be said to be stable. With more than 80% of the banks being privately owned, rescuing banks basically do not belong to State responsibilities. Most of the banks active in Hungary have an international "background" consisting of very strong financial groups. Should nevertheless a situation arise, in which the operation of a bank endangers the stability of the banking system, the National Bank of Hungary may give, as a '"lender of last resort", in accordance with the Act on the Central Bank, special credit to that bank.

Competition Regulation in banking

Question

19) Please describe the application of the national competition law to the banking sector. Are there any exemptions to the application of the national competition law that apply to banks? Are banks subject to the general competition law or to specific competition rules (i.e., are there special provisions relating to bank mergers, inter-bank agreements, and so on)? If the latter is the case, are these sector-specific competition rules more restrictive or less restrictive than the national competition laws? What was the public policy reason behind sector-specific competition rules?

Answer

In the same way as other sectors of the economy, the banking sector falls under the scope of Act LVII of 1996 on the Prohibition of Unfair and Restrictive Market Practices (the Competition Act). The competition rules in Hungary are the same for each of the sectors.

The Competition Act contains two special provisions relating to the banking sector. One of them concerns the turnover thresholds of the merger control. According to the general rule of the Act, for a concentration of firms, the authorization of the Hungarian competition authority must be sought in cases where the aggregate net turnover of the firms concerned exceeded HUF 10 billion in the preceding business year and further additional thresholds-related requirements were also met. In the case of concentrations of banks, 10% of their total assets must be taken into account in place of net turnover, but the HUF 10 billion threshold also applies. According to the other special provision, temporary acquisitions of control or ownership for a one-year period at the longest by credit

institutions for the purposes of preparing a resale do not qualify as concentrations provided that they do not exercise their controlling rights, or exercise them only to an extent which is indispensable to the attainment of these objectives. The Hungarian competition authority, on request where such credit institutions can show that it was not possible to carry out the disposal within one year may extend that period.

Question

20) Who enforces the competition laws in the banking sector? Is it the sole responsibility of the national competition authority? If not, is the responsibility shared with another agency, or solely the responsibility of another agency? Does this other agency also deal with prudential regulation? If the responsibility is shared, how is it shared? (i.e., are some components of competition law, such as horizontal agreements, the responsibility of one agency and other components, such as the regulation of mergers, the responsibility of another?) Does one agency have a veto over another, or consensus is required? If another agency has sole responsibility for all or part of the competition laws in the banking sector, does the national competition authority have the right to provide advice? Has it ever done so? How was it valued by the regulatory agency? Please comment on the decisions taken by this other agency, from a competition perspective.

Answer

In the first instance, also the court has competence in cases of the banking sector falling under the scope of the Competition Act. This "division of work" is, however, not sector-specific, but is a general division of the competences that is based on a provision of the Competition Act, which sets out that proceedings in cases of the infringement of the provisions of the Act directed against unfair competition (except against unfair manipulation of consumer choice by consumer fraud and by the application of business methods that restrict, without justification, the freedom of choice of consumers) belong to the competence of the court. In other cases under the Competition Act the Hungarian competition authority functions as an independent decision-maker, against the decisions of which a legal remedy may be sought by request for a review, by the court, of the decision in question. This does not mean, of course, that the competition authority does not request, during its investigations, the supply of relevant data or information of other institutions, but it remains still the competence of the competition authority to reach the decision.

Question

21) Please comment on particular actions taken by the competition authority:

(a) In the case of mergers, what has been the approach of the competition authority to market definition? Which separate markets were identified, why? Have you treated banks as offering a bundle of services to each customer or as offering a multi-product range, with different markets for each product? What was the geographic scope of each market? Has the Internet or telephone banking appreciably affected questions of market definition? Was the informal sector considered in the antitrust analysis of bank behavior?

Answer

Market definition depends always on the case at issue. It is carried out on the basis of the activities of the participants of the merger. Banking activities are generally examined in the respective parts for retail and corporate deposits and loans and bankcards of the market. In cases in which the firms concerned are also active to a significant extent in other parts of the market (such as in leasing activities of securities trading), the likely influence of the transaction to those parts of the market is

examined, too. Typically, geographic market is defined as being countrywide; it occurs, however, that likely regional affects of a merger are also assessed.
As an example of this last investigative measure, the merger of the respective Hungarian subsidiaries, with an altogether 10 to 25% market share of the two, depending on the market in question, of the KBC N.V. and the ABN AMRO Bank N.V. should be mentioned where it was examined, with regard to the regional allocation of the branches, whether problems for their clients might arise as the consequence of a possible closing down of some of those branches. It could be established that both of the banks had branches in the capital (where the highest number of their branches operated) and in county seats, in respect of the smaller localities their networks of branches were complementary in nature. In each of the localities, however, where only one of the banks concerned by the merger had a branch, at least one but typically more than one other credit institution had branches; hence, a possible counting down would not have caused problems for the consumers.
It happened only in recent times that services in package and electronic banking services started to become more and more popular but could not become widely distributed (mainly due to consumer habits). The Hungarian competition authority has had no practice yet in examining them.

(b) In the case of horizontal arrangements, have you found that features of the banking industry facilitate collusive arrangements? Have network effects and/or inter-bank agreements relating to, say, ATMs, electronic processing of transactions, payment systems or joint marketing of credit/debit cards raised competition concerns? Have concerns been raised about bank collusion in the wholesale markets, such as the market for government debt?
Have there been specific instances of abuse of dominance or vertical arrangements which have raised competition concerns? For example have there been instances by dominant companies requiring customers to purchase a product in order to get product customer wants?

Answer

The Hungarian competition authority examined one horizontal inter-bank agreement until now. The agreement aimed at eliminating market-disturbing dealers in the area of bankcard-acceptance.
At the time when the agreement was concluded, the issuance of bankcards was one of the banking services most dynamically in progress. The number of bankcard-abuse cases was, however, the multiple of what they amounted to, as an average, in Europe. This situation could not be remedied by means of only the development of IT systems processing bankcards-backed turnover; in consequence, an exchange of the information collected about the typical methods and ways of abuse and the elimination of the market-disturbing players became necessary. The agreement mentioned above was concluded with a view to eliminate, based on unified principles, market players that were likely to disturb the operation of the market or restrict their activities and, on the other hand, to prevent new market entry of those market players already eliminated or restricted. The parties to the agreement could not supposed to have the intention to collude, as they were interested in having a fear competition and reaching a turnover as high as possible. The elimination of market-disturbing card-acceptors made the distribution more reasonable and increased the safety of the use of cards, resulting in this way in an increased competitiveness of the cards as products. By increasing the safety of the use of cards, a higher level of safety for the consumers was created, too. The restrictive effects of the agreement did not go beyond the extent that was necessary for the attainment of its objectives. The cooperation did not restrict the competition in other fields between the parties and the parties remained free to set their contracting terms and their prices.
Banks issuing cards on the Hungarian market generally have their own ATMs offering free access, though at a higher fee (varying from bank to bank) for cash withdrawals, to cardholders of any other bank, too. In addition, two further networks exist (one of which is independent from any of the banks) that can be used by cardholders the issuing bank of which concluded a related contract with

the owner-company. Fees charged for the use of the ATMs and published in the list of terms of the banks are different; each of the banks set its prices in compliance with its own business policy.

Question

22) Are there any other particular issues or experiences in the enforcement of competition law that you think would be of interest to other competition authorities? If so, please describe them briefly and, where relevant, provide citations to any relevant publications.

Answer

In Hungary, the scope of the Competition Act covers, in addition to the rules of antitrust, the prohibition of unfair market practices. It should be mentioned here that the Hungarian competition authority has faced several cases the subject of which was the misleading of consumers (e. g. by false promises relating to the returns). In a wider sense, to promote efficient competition, the importance of laying down appropriate requirements in the professional regulations of banks in respect of keeping consumers informed should be underlined here. Consumers who are unable to compare the products offered by different banks (e.g. because banks use a huge range of credit fees of different kind and size) do not have the possibility to choose or decide in a manner which efficient competition would require they should have.

Question

23) Have there been any important regulatory changes (relating to any of the components of the regulatory regime discussed in the previous paragraphs) in the past two years? If so, briefly describe the situation before the change and the main effects of the change.

Answer

In connection with Hungary's accession to the EU, several amendments of mainly procedural nature of the Hungarian Competition Act came into force as of 1 May 2004.

<u>Annex to the "Banking, competition and economic development in Hungary (answers to the questionnaire)"</u>

Commercial banks, mortgage banks and savings banks (for housing finance) active in Hungary

Commercial banks:

Általános Értékforgalmi Bank Rt. (General Banking and Trust Co. Ltd)
Bank of China (Hungária) Hitelintézet Rt.
BNP Paribas Hungária Bank Rt
Budapest Hitel- és Fejlesztési (Credit and Development) Bank Rt.
Calyon Bank Magyarország Rt.
CIB Közép-európai Nemzetközi Bank Rt (Central-European International Bank Ltd)
Citibank Rt
COMMERZBANK (Budapest) Rt.
Credigen Bank Részvénytársaság
DEUTSCHE Bank Rt.
Dresdner Bank (Hungária) Rt.
EB und HYPO BANK BURGENLAND SOPRON Rt.
ELLA Első Lakáshitel Kereskedelmi Bank Rt.
ERSTE Bank Hungary Rt.
Hanwha Bank Magyarország Rt
HVB Bank Hungary Rt.
IC Bank Részvénytársaság
ING Bank (Magyarország) Rt.
Inter-Európa Bank Rt.
KDB Bank (Magyarország) Rt.
Kereskedelmi és Hitelbank Rt.
Magyar Cetelem Bank Rt.
Magyar Külkereskedelmi Bank Rt.
Magyar Takarékszövetkezeti Bank Rt. (Bank of Hungarian Savings Co-operatives Ltd.)
Magyarországi Volksbank Rt
Merkantil Váltó és Vagyonbefektetési Bank Rt. Merkantil Bank Ltd.
Országos Takarékpénztár és Kereskedelmi Bank (OTP Bank Ltd. National Savings Bank)
Porsche Bank Hungaria Rt.
RAIFFEISEN BANK Részvénytársaság
WestLB Hungaria Bank Rt.

Mortgage banks:

FHB Földhitel- és Jelzálogbank Rt (FHB Land Credit and Mortgage Bank)
HVB Jelzálogbank Részvénytársaság (HVB Mortgage Bank Inc.)
OTP Jelzálogbank Rt. (OTP Mortgage Bank Ltd)

Savings banks (for housing finance):

Fundamenta-Lakáskassza Lakás-takarékpénztár Rt..
OTP Lakástakarékpénztár Rt. (OTP Building Society Ltd.)

QUESTIONS

Role of banking in financing business activity in your country

Question

1) Besides the traditional deposit-taking and credit-offering functions, what additional services are provided by banks in your country:

Services for depositors like:

- **Credit cards services, paying bills for depositors**
- **Consumer loans [auto, personal, bill paying, etc]**
- **Mortgages**
- **Life insurance**
- **Financial advisors; Management of investment funds; Asset management**

Services for firms like:

- **Banking services for firms (business liquidity loans, capital investment loans)**
- **Brokerage services**
- **Corporate banking services**
- **Investment banking (Stock Exchange listing, trading, clearing and settlement services)**

Answer

Several Indonesian banks offers services such as Credit Cards, billing payment, consumer loan, mortgage and non bank services such as financial advisor, consultant and also asset management. In terms of corporate banking, many services are offered such as loans, brokerage and investment banking (using their subsidiaries and affiliations).

Question

2) With respect to the list of financial services contained in 1) are there regulatory limitations that constrain the ability of banks to offer some of them? Are there regulatory limits on the ability of banks to lend?

Answer

Yes, there are limitations for product and services that can be offered by bank (regulated by Bank Indonesia). For example, bank cannot offer insurance product directly (prohibited by Law no 10/1998 article 7). There is also legal lending limit regulation, which prohibits bank to give loan/credit no more than 10% to their subsidiaries/group. The legal lending limit regulation is imposed by the Central Bank (Bank Indonesia) especially Bank Indonesia Board of Directors Decree No 31/177/KEP/DIR/1998 and later revised by Bank Indonesia Regulation No 2/19/PBI/2000.

Question

3) **Considering each service as detailed in question 1), please provide a brief description of the market structure, considering that for most of these services banks compete also with non banks and that if the size of the market is local you should provide some sort of nation-wide averages:**

(g) is there a single provider for each product? Are there a few large providers? Are there many providers?

Answer

In general, there are few large providers (proximately 10 banks) for such banking products and services. Usually bank with strong equity has the capabilities to offer wide variety and highly differentiated product and services, meanwhile bank with modest capital would focus mainly to traditional product and services.

Question

(h) Is there one single consumer of the product considered? Are there a few large entities as major consumers? Are there many consumers?

Answer

There are many customers for bank product and services. Usually bank customers are divided into retail and corporate customer. No significant evidence that bank product and services are only available to few numbers of customers.

Question

(i) In geographic terms, how wide is the market for the products concerned?
[are customers' branch/location dependent? What is the willingness of customer to use distant branches?]

Answer

Many large banks have already opened hundreds to thousands of branches. Most of them are located near the market or business location (market based). No information about customer willingness to use distant branches. Nevertheless, with the trend of e banking, on line system, joint electronic payment system and ATM network, the scope of banking market is relatively wide. Few large bank has already implement many of Information Technology that enable bank to offers variety of services on line, meanwhile small number of bank with moderate capital already able to offer limited on line services.

Question

4) **Please briefly describe the paperwork required to switch bank for a depositor and whether there are fees (how high?) that banks require to close an account**
[what are the fees associated? What are the fees for opening an account, minimum balances, fees for closing an account]

Answer

In general, there is no significant paperwork needed in order to switch bank. To open or closing an account, there are some fee that have to be paid by customer, but the amount is relatively small. Some bank made restriction to open an account with beginning balance minimal IDR 500.000. There are also limitations (in form of minimal balance) in opening deposits (especially time deposit). Closing an account such as time deposits which is not reaching maturity period yet, would be penalized by certain amount.

Question

5) Is access of bank financing by the business sector based on:

a) collateral guarantees (*i.e.* real estate)?

Answer

Yes, collateral is needed and mandatory to access bank financing.

b) political patronage?

Answer

No information about the role of political patronage. In normative form, no.

c) nature/size/length of time of existence of the firm?

Answer

Yes, the size/nature of the firm do become consideration in bank credit decision.

d) accurate risk assessment of the project to be financed?

Answer

Yes, bank would asses the risk associated by the project to be financed. In general, Indonesian banking is in the earlier stages of adopting risk management principle, as mandated by Bank Indonesia, in accordance to the Bassel Accord.

Question

6) What is the importance of the informal non institutional sector (families, friends etc.) for providing credit to the business sector, especially to smaller firms?

Answer

No adequate information regarding the role of family and friends in credit decision. Although, smaller bank tends to use personal relationship strategy to maintain their market share.

Question

7) **Does lender have access to customer credit report from reporting agency (Equifax, etc)? How transparent are business financial statements – e.g. bank more likely to lend to publicly traded company because more financial information is available? Does the regulator collect and provide to all banks an up to date register of all major debtors in the country (with a precise indication of the risk associated with each debtor), so that also a new entrant in banking can provide credit to local entrepreneurs? Is the information costly? Timely? Reliable? How do banks measure risk of borrower?**

Answer

Indonesia doesn't have a credit rating agency yet, especially for banking. Information regarding customer is relatively costly, because many bank have to conduct their own research to asses the potential customer. Banks are obliged to submit their financial report (quarterly and yearly) both to the Central bank and public (using news media). No certain information about the validity of those report, but yearly financial report are prepared and commented by accredited public accountant. No adequate information about credit to public firms yet.

Question

8) **In general do the official accounts of business firms provide a clear picture of their credit worthiness or do companies regularly have a double set of accounts (one for fiscal and one for company management purposes)?**

Answer

Indonesian companies which already listed in stock market must publish their annual report which is prepared by accredited public accountant (verified by the Indonesian Capital Market Supervisor). No adequate information regarding the double financial report yet.

Question

9) **In the case of a non performing loan what are the options open to a bank (selling the collateral, suing the debtor, asking for government relief, etc.)? In the answer please provide some indication on the timing of each procedure and on the costs involved.**

Answer

To manage the NPL (non performing loan or bad debts), banks usually perform many strategies, that include non litigation way, such as write off and factoring and litigation procedures. Write off methods must be approved by stockholder, while the litigation procedures would relatively takes time and effort. No information regarding the cost and the timing of those procedures yet.

Question

10) **Do businesses in general have a credit relationship with only one bank or is the phenomenon of multi banks credit widespread?**

Answer

Companies usually rely on many sources to finance their activities. Other than bank, usually companies use capital market instrument such as stocks and bond as source of financing. In general, many (large) companies would build portfolio of credit from many sources (multi banks credit) rather than one bank credit relationship policy.

Sector-specific regulation in banking: Institutional setting

Question

11) **Please describe the institutional structure of banking regulation in your country. What body/agency is responsible for bank regulation? Is there more than one regulatory agency (such as a "Banking Commission", or a "Financial Services Authority" - in some countries this role is played by the central bank)? To whom is/are it/they responsible or accountable (prime minister/finance minister/legislative body…)? What is the form of this institution, its principal functions and statutory objectives? How transparent is its decision making? Are its decisions published? What discretion does it have? How does it exercise that discretion? Etc.**

Answer

The hierarchy of banking regulation starts (from higher ranking) Law no 10/1998 and Law no 23/1999, then Government regulation, Bank Indonesia Regulation and the last is Bank Indonesia Board of Director Decree.

The Indonesian Central bank or Bank Indonesia is the regulatory body for Indonesian banking industry. Other non bank institution would fall to the authority of Minister of Finance (such as Insurance) while the capital market related institution would fall under the authority of BAPEPAM (the Indonesian Capital Market Supervisor). Bank Indonesia is responsible directly to the president, and also has to make periodic report to the public (include parliament). More about Bank Indonesia and their authority (include legal basis based on Law no 23/1999) can be found at www.bi.go.id.

Sector-specific regulation in banking: Structural regulation

Question

12) Can you describe the rules on branching and new entry in your country?

Answer

Branching or new entrant is permitted only by the decision of Governor Council of Central Bank. In addition to administrative document, Central Bank also asked new entrant to present a feasibility study that at least consist of economical potency, market opportunity, number of banks, and competition among them. In general, branching regulation is mentioned in Law No 10/1998 especially article 18-20. . In general, branching decision needs approval from regional office of Bank Indonesia. Branching policy for bank (to open new branches in general) is subject to the approval from board of governor, Bank Indonesia

Question

13) Is the entry of foreign banks specifically regulated? Are there restrictions to their operations in your country, both in terms of market size and of services offered? Once foreign banks have entered the domestic market, are they subject to rules different than those applying to national banks?

Answer

Regulation concerning foreign bank in general are mentioned in Law No 10/1998, especially article 22 and Bank Indonesia Regulation No 2/27/2000 and especially Bank of Indonesia Board of Director Decree No 32/37/KEP/DIR/1999. In general, partnership with local/domestic bank is required for foreigner to build/set up bank in Indonesia. The forms of branching allowed for foreign bank are representative office, branch and subsidiary. Other than that, in general, either foreign or domestic bank, are subject to the same regulation.

Question

14) In the case of financial investments into a bank capital (by other banks or by non banks) are the principles of safety and prudence exactly defined (either by the law or by the regulator) so that an investor can anticipate the likely response? How much discretion does the regulator have? How has it been used?

Answer

Inter-bank fund placement is regulated by article 6, 7 and 10 from Law no 10/1998. In general, bank can place fund to other bank or other financial institution (insurance, financing, etc) subject to the approval and supervision from Bank Indonesia.

Question

15) Is the expansion of banks regulated? Are there explicit limits to its geographical concentration? Is there regulatory supervision on the opening of new branches?

Answer

Regarding bank expansion, there are regulations concerning those activities issued by Bank Indonesia but in general, besides branch regulation, there are no specific regulations about geographical concentration.

Sector-specific regulation in banking: Behavioral regulation

Question

16) Are there regulatory restrictions on pricing (interest rate controls and other control on prices and fees)? How are they administered? Are there restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements not to hold other securities; including requirements not to hold the control of non financial companies)?

Answer

Up until present condition, there are pricing control mechanism, especially for deposits interest rate. Under the blanket guarantee scheme, Bank Indonesia would issue a benchmark rate for deposit interest rate as a maximum/ceiling price. Any banks which price beyond the maximum price, then their fund would not be guaranteed by the central bank. Also there are regulation about cross ownership include the management of banks and board of commissioners. In general, there are no formal restrictions about bank's asset portfolio. For investment purposes, bank is allowed to invest certain amount of fund to several financial instruments such as government bonds and other securities. But, there are strict limitations about bank's ability related to fund placement. This restriction is mentioned in Law no 10/1998 especially article 10.

Question

17) Are there requirements to direct credit to favored sectors and enterprises?

Answer

Until now, there are no formal regulations about credit distribution, but moral suasions sometimes issued by related institutions (especially government institution) to affect bank's credit distribution policy.

Question

18) Besides the formal statutory regime, are there any understandings or expectations about the actions of, say, the central bank (such as "lender of last resort" or "too big to fail") or other government agencies which could affect the behaviour of banks?

Answer

Yes, the Central Bank still have "lender of the last resort" function, although under very limited condition. The trends (based on Indonesian Banking Architecture recently issued by Bank Indonesia) is that large bank (too big to fail) would be preferred, and then suggesting many smaller banks to merge or consolidate. There are also many institutions (other government agencies/department) that could affect banks behavior, such as the government policy to prioritize small and medium scale business.

Competition Regulation in banking

Question

19) Please describe the application of the national competition law to the banking sector. Are there any exemptions to the application of the national competition law that apply to banks? Are banks subject to the general competition law or to specific competition rules (i.e., are there special provisions relating to bank mergers, inter-bank agreements, and so on)? If the latter is the case, are these sector-specific competition rules more restrictive or less restrictive than the national competition laws? What was the public policy reason behind sector-specific competition rules?

Answer

Basically, Indonesian Competition Law (Law No 5/1999) is applicable to all industrial sectors (cross industry) include banking and financial industry. It means, banks are subject to general competition law (Law No 5/1999). Until present time, no exemption made to specific banking industry yet. The Banking law also covers some of competition issues such as interlocking directories, cross ownership and merger/acquisition, just like Law No 5/1999. And, to some extent, banking regulations such as mentioned before, are stricter than competition law, for prudential purposes.

Question

20) Who enforces the competition laws in the banking sector? Is it the sole responsibility of the national competition authority? If not, is the responsibility shared with another agency, or solely the responsibility of another agency? Does this other agency also deal with prudential regulation? If the responsibility is shared, how is it shared? (i.e., are some components of competition law, such as horizontal agreements, the responsibility of one agency and other components, such as the regulation of mergers, the responsibility of another?) Does one agency have a veto over another, or consensus is required? If another agency has sole responsibility for all or part of the competition laws in the banking sector, does the national competition authority have the right to provide advice? Has it ever done so? How was it valued by the regulatory agency? Please comment on the decisions taken by this other agency, from a competition perspective.

Answer

In general, KPPU is the institution mandated by Law No 5/1999 to implement and supervise the business competition in Indonesia. KPPU authority also covers competition issues in banking, while the banking regulator, Bank Indonesia, would focus on maintaining stability and prudentially of banking industry as a whole. The task and authority of the two regulators would coincide (for specific case such as merger, horizontal agreement etc). To anticipate any negative impact in the future, Bank Indonesia and KPPU has already made several intensive discussion and coordination. This cooperation scheme is a kind of 2 way communication, so that either Bank Indonesia or KPPU would be able to perform its duties optimally.

Question

21) Please comment on particular actions taken by the competition authority:

(a) In the case of mergers, what has been the approach of the competition authority to market definition? Which separate markets were identified, why? Have you treated

banks as offering a bundle of services to each customer or as offering a multi-product range, with different markets for each product? What was the geographic scope of each market? Has the Internet or telephone banking appreciably affected questions of market definition? Was the informal sector considered in the antitrust analysis of bank behavior?

Answer

For defining relevant market (not only for merger cases), KPPU would use both product and geographical market definition based on Law No 5/1999. Until present time, KPPU haven't handle any merger case involving bank, because currently Indonesian banking is still under the recovery program initiated by the Government. Many of mergers between banks are considered as part of those recovery programs. With the variety of product and services offered (bundled) and the rapid development of information technology such as internet banking and on line services, the scope of the market tends to be broader.

(b) In the case of horizontal arrangements, have you found that features of the banking industry facilitate collusive arrangements? Have network effects and/or inter-bank agreements relating to, say, ATMs, electronic processing of transactions, payment systems or joint marketing of credit/debit cards raised competition concerns? Have concerns been raised about bank collusion in the wholesale markets, such as the market for government debt?
Have there been specific instances of abuse of dominance or vertical arrangements which have raised competition concerns? For example have there been instances by dominant companies requiring customers to purchase a product in order to get product customer wants?

Answer

There are some concern regarding the competition issues related to horizontal agreement between bank (include network services). Specifically, some issues such as tying practices in banking has already raised many question among stakeholder include customer. In general bank's strategy, they would offer wide variety of product and services to customer, and the customer has the freedom to choose. These behaviors also affected by the recent regulation from Bank Indonesia. The regulation known as "know your customer principle" obliged banks to collect all necessary information about their customer. In practice, bank would relate such regulation with the offering of product and services (example, have to become bank customer to be able to enjoy variety of services provided by the same bank). All of these issues are still under supervision and scrutiny of KPPU and until now, no conclusion ever made yet.

Question

22) Are there any other particular issues or experiences in the enforcement of competition law that you think would be of interest to other competition authorities? If so, please describe them briefly and, where relevant, provide citations to any relevant publications.

Answer

The competition issues in bank are very interesting. In fact, KPPU would still need a lot of information from other institution worldwide regarding those issues.

Question

23) Have there been any important regulatory changes (relating to any of the components of the regulatory regime discussed in the previous paragraphs) in the past two years? If so, briefly describe the situation before the change and the main effects of the change.

Answer

For the past 2 years, Bank Indonesia has issued a lot of regulations; two of them are significant; the forming of Indonesian Banking Architecture and Know Your Customer Principle (already explained in questioned 21.b). The forming of Indonesian banking Architecture would reduce the number of banks in Indonesia into a few large numbers of banks. These changes in regulation would affect some competition issues and has become important consideration for KPPU in the relation with Bank Indonesia. More information about these regulations can be obtained at www.BI.go.id

Banking, competition and economic development: KOREA

Current Situation of Banking Industry in Korea

In Korea, the banking business means a business of lending funds raised by bearing debts from many unspecified persons through the receipt of deposits and issuance of securities and other bonds. Banking operations can be divided into three categories: original, incidental, and concurrent businesses.

Original banking business refers to basic functions of banks as financial intermediaries and includes deposit-taking, lending and currency exchange. Incidental banking business refers to operations incidental to the original banking businesses, or operations considered helpful to the socioeconomic functions of banks. The scope of incidental banking activities has recently been expanding. Banks can also perform concurrent business after receiving authorization by the Financial Supervisory Commission (FSC). Concurrent business includes trust and credit card businesses.

As of the end of 2004, 19 domestic banks (8 nationwide banks, 6 regional banks and 5 specialized banks) and 37 branches of foreign banks are operating in the Korean market with 609.3700 trillion won in loans and 767.0690 trillion won in deposits.

Currently, the profit structure of domestic banks is improving gradually while their non-performing assets are decreasing. Because of little fluctuation in interest margin, non-interest revenues, such as insurance premiums and net gains on beneficiary certificates, posted higher growth rate than interest revenues. However, non-interest revenues account for 25% of total revenues, lower than that of advanced countries.

The Banking Industry Regulatory Authorities

As a financial reform program agreed upon between the Korean government and the IMF required the establishment of an integrated supervisory agency, a new agency was created under the Act on the Establishment of Financial Supervisory Organizations which came into force in April, 1998. The Financial Supervisory Commission (FSC) was established under the office of the Prime Minister as an integrated financial regulator that, along with its executive body, the Financial Supervisory Service (FSS), carries out supervision not only on banks, but also on almost all financial institutions.

The Ministry of Finance and Economy takes charge of promulgating and amending laws and regulations on the banking industry while the Bank of Korea and the Korea Deposit Insurance Corporation (KDIC) has limited supervisory authority.

1. Financial Supervisory Commission

The Financial Supervisory Commission was created on April 1, 1998, as an administrative agency under the office of the Prime Minister. The FSC is responsible for the promulgation and amendment of financial supervisory rules and regulations, the approval and permission of matters relating to financial institutions' operations, and the examinations and sanctions on financial institutions.

The FSC is composed of nine commissioners: six standing commissioners and three non-standing commissioners. The six standing commissioners are as follows: Chairman appointed by the President after the State Council deliberation, Vice Chairman appointed by the President on the recommendation of the Minister of Finance and Economy, an accounting expert recommended by the Minister of finance and economy, a financial expert recommended by chairman of the FSC, a legal expert recommended by the Minister of justice, and a representative of the business community recommended by chairman of the Korea Chamber of Commerce and Industry. The term of office of the standing commissioners is three years, and they can be reappointed only once. Non-standing commissioners are composed of vice minister of finance and economy, deputy governor of the Bank of Korea, and chairman & president of the KDIC.

2. Financial Supervisory Service

The Financial Supervisory Service was established on January 1, 1999, as a special corporation with no capital to carry out examination and supervision on the banking industry under the instruction of the FSC. The FSS Executive Board consists of one Governor, no more than four Deputy Governors, no more than nine Assistant Governors and one Auditor. The Chairman of the FSC concurrently holds the position of Governor of the FSS. Deputy Governors and Assistant Governors are appointed by the FSC upon the recommendation of the FSS Governor while the Auditor is appointed by the President on the recommendation of the FSC. The term of office of the Executive Board members is three years, and they may be reappointed only once.

3. Overview of Banking Industry Supervision

The banking sector is different from other industries in that the sector promotes a high level of public interest in addition to pursuing profits. Therefore, sound nurturing and development of the banking sector plays an important role in the growth of the national economy. In this context, most countries have a stronger regulatory and supervisory system on the banking industry than on other industries in an effort to maintain the stability of the financial system and protect depositors. The purpose of the supervision is to encourage sound management of banks, enhance the efficiency of financial intermediation, protect consumers of financial services and create a sound culture of credit, thus contributing to the stability of the financial market and the development of the national economy. To that purpose, the Banking Act was enacted to set up a comprehensive regulatory regime on the structure and operations of banks by stipulating matters regarding entrance to the banking industry, ownership and governance structure, management guidance, scope of operations, and exit from the industry. Since the financial crises in 1997, a great deal of improvement has been made to the regulatory regime. For example, standards for authorization and approval of banking operations have been improved. Also, the system of ownership and governance structure in financial institutions has been changed for the better to meet the global standard. Other examples are the overhauling of Regulation on credit concentration, the improvement of loan loss provisioning standards, and the introduction of asset soundness classification, risk-weighted BIS capital requirement and risk management evaluation.

Regulations on the Structure of the Banking Industry

1. Regulations Regarding Entrance to the Banking Industry

Anyone who intends to conduct the banking business needs to obtain authorization from the FSC. In determining whether to grant authorization, the FSC confirms the feasibility of a

business project, the appropriateness of paid-in capital, stockholders' composition and stock subscription capital, the managerial abilities and sincerity of the promoters or the management, and the public interest. The amount of minimum paid-in capital has to be not less than 100 billion won for nationwide banks and not less than 25 billion won for regional banks. And when a foreign bank intends to establish any branch or office to conduct the banking business in Korea, or close a branch, it must also obtain authorization from the FSC. Matters subject to the authorization of the FSC include carrying out concurrent businesses, a division or a merger with any other financial institution (including a division-merger), dissolution or closure of banking business, and transfer or takeover of business operations in whole or in part. Amendment of the articles of association and reduction in paid-in capital has to be reported to the FSC.

With regard to the establishment of bank offices, relevant provisions in the Banking Act were amended in January 2000. Under the revised Act, in case where banks intend to newly establish business places or offices in foreign countries, or relocate its head office in other Special Metropolitan City, Metropolitan City, or Province, they have to prepare in advance the plans for new establishment or relocation and make a consultation with the FSC.

2. Regulations on Ownership Structure of Banks

Regulation on the ownership structure of financial institutions can find its legal ground in provisions for stock-holding limit by same persons in the Banking Act. The provisions were introduced when the Banking Act was revised in December 1982, to prevent industrial capital from controlling financial capital.

Currently, the same person cannot hold stocks of a financial institution more than 10% of the total number of voting stocks issued by commercial banks and more than 15% of voting stocks of regional banks. Non-financial operator cannot hold more than 4% of the total number of issued voting stocks of a financial institution. However, the same person may hold stocks in excess of the approved limits after obtaining additional approval from the FSC under certain conditions.

Approval requirements are about accountability for insolvency in the past, financial soundness and type of business (for foreigners only). These requirements were set to exclude those who might undermine soundness of banking management. Anyone who intends to hold stocks exceeding the limits must apply for an FSC approval through the Governor of the FSS. The FSC may restrict the timing and method of share acquisition if the agency thinks it necessary based on qualifications and distribution of stocks the bank holds.

3. Regulations on Governance Structure of Banks

Board of directors of a bank must be composed of executive directors and outside directors. A bank has to appoint at least three directors, and the number of outside directors should be more than 50% of the total number. Outside directors are selected and appointed by the general meeting of stockholders among those recommended by the outside director candidate recommendation committee (more than half of the committee members should be outside directors). The term of office is three years for executive directors and one year for outside directors under the articles of association in most banks. Some banks, however, have articles of association stipulating that the selection and appointment of executive directors whose term of office is three years or less be decided by the general meeting of shareholders.

Anyone falling under one of the followings cannot be an officer of a financial institution: a minor, a person who is incompetent or quasi-incompetent, a bankrupt who has not been reinstated, a person who has been sentenced to imprisonment and for whom five years have not elapsed since he completed the sentence, or a person for whom five years have not elapsed since he was dismissed or removed by disciplinary punishment under the Banking Act, etc. Specific matters on the qualifications for officers of financial institutions are determined by the FSC. When a bank intends to appoint its executive directors, it has to check for the propriety of the qualification standards, and the results must be reported to the Governor of the FSS after the general shareholders' meeting. The selection of a candidate for the presidency of a bank or a standing member of the audit committee, however, should be reported prior to a board of directors meeting and a general meeting of shareholders. For listed or registered banks, the selection has to be reported immediately upon a notification or announcement of a general shareholders' meeting.

According to the revision of the Banking Act and the Commercial Act, all banks abolished the existing audit system and introduced an audit committee system at the general shareholders' meeting in 2000. The audit committee is under the board of directors and consists of three directors or more. Not less than two thirds of the total members should be outside directors. Members of the audit committee have the same authority as auditors under the Commercial Act.

Banks are required to lay down the internal control standards and comply with them. The internal control standards refer to the basic procedures and standards to be observed by the officers and employees in performing their duties, in order to observe the Acts and subordinate statutes, make s sound operation of assets, and protect the depositors. Also, banks must appoint one or more persons who are to inspect whether the internal control standards are observed, and in case of any violation of the standards, investigate it and report on it to the audit committee.

Regulations on the Behavior of the Banking Industry

1. Guidance for Sound Management

- Encouraging a healthy equity capital structure

The minimum level of equity capital is 100 billion won for nationwide banks and 25 billion won for regional banks and the BIS capital ratio is 8%. Banks are also required to set aside a legal reserve (more than 10% of the net income for the year after tax) and meet the ratio of allowance for severance and retirement benefits (100%).

- Regulation on adequate liquidity

The liquid asset ratio should be maintained at 100% or more, and investment in marketable securities is limited to 60% of equity capital.

- Improving asset soundness

Financial institutions must classify the soundness of their holding assets into five categories: normal, precautionary, substandard, doubtful and estimated loss. Banks are required to write off assets classified as doubtful or estimated loss. When the write-off performance is insufficient, the Governor of the FSS may request the banks to write off specific non-performing assets.

- Management performance evaluation, emergency measures and prompt corrective action

The headquarters of financial institutions, foreign bank branches in Korea, and overseas branches and subsidiaries of financial institutions are subject to the evaluation of management performance. The ratings of evaluation are classified into five grades. When a bank is deemed to threaten to cause serious damage to the interests of depositors, such as threatening to go bankrupt or insolvent, the FSC may take emergency measures, like restriction on taking deposits and granting credits and suspension of payment to all or parts of deposits. In terms of prompt corrective measures, the financial supervisory agencies may issue a management improvement recommendation, requirement and order.

2. Supervision on Subsidiaries of Bank

Under the Banking Act, a subsidiary is defined as a company in which a bank holds more than 15% of the issued voting stocks (including contribution quotas). The Act also stipulates business categories of subsidiaries and the ceiling on the amount of investment in subsidiaries. Financial institutions can hold the issued voting stocks in a company that falls under any category of businesses as determined by the FSC or obtains approval from the FSC as necessary for promoting corporate restructuring. And a bank may invest in subsidiaries within the limit of 15% of its equity capital.

Banks must follow reasonable conditions in their transactions with subsidiaries, and they must not give preferential treatment to subsidiaries without justifiable reasons, bear the expenses of subsidiaries in lieu without justifiable reasons, violate independence and soundness of subsidiaries' management, influence subsidiaries and customers to make transactions that may bring about the conflict of interest, and share with subsidiaries information of customers without consent. The ceiling on credits extended to subsidiaries is also stipulated by the Act.

3. Regulation on Large Credit Risk

No bank can extend credits exceeding 25% of its equity capital to the same borrowers and 20% to the same individual or corporation. And the total amount of large credits cannot exceed five times of the bank's equity capital.

4. Inspection and Sanctions

In case where deemed there exist concerns about impeding the sound management as a bank violates the Banking Act or any regulations, orders or instructions under the Act, the FSC may issue orders for correction of the relevant offenses and partial suspension of business for less than six months upon the recommendation of the FSS Governor, or have the FSS Governor take appropriate measures, such as suspending the relevant offenses and issuing a warning. The FSC may order the suspension of all the business for up to six month or cancel the authorization of banking business when a bank obtained the authorization of banking business by false or other wrongful means, violated the contents and conditions of authorization, and conducted the business during the business suspension period, and when there are concerns about serious damage to the interest of depositors and investors in violation of the Banking Act or orders or dispositions under the Act.

With regard to sanctions against officers, the FSS Governor may recommend dismissal of an officer or suspend the exercise of his functions for six month or less. In terms of sanctions against employees of a bank, the FSS Governor may request the bank to take disciplinary measures, such as dismissal, suspension, deduction of salary, or reprimand.

Competition Law Enforcement in the Banking Industry

The KFTC applies the competition law to the banking industry like other industries. There is no special exemption for the industry. It can be said that the competition law enforcement in the banking sector (in areas like merger, share acquisition, and abuse of market dominance) is carried out entirely by the KFTC. That's because the KFTC determines competition-restrictiveness through prior consultations when the FSC considers an approval or authorization of a merger or share acquisition in the banking industry.

The KFTC has in place the M&A Review Guidelines which is applied to the banking sector in determining market definition, the existence of controlling relation and competition-restrictiveness. With regard to the market definition in the review of a bank M&A, there has not been any case of segmented market definition because, currently, there are no banks exclusively in charge of Internet banking or telephone banking. Considering a rapidly changing financial environment, however, more segmented market definition is likely to be needed. So far, there has been no case of abuse of market dominance by banks. As banks began to engage in credit card operations as part of concurrent businesses, the KFTC detected and took appropriate measures against concerted acts by banks, such as refusal to transaction and cartel of credit card fees.

QUESTIONS

Role of banking in financing business activity in your country

Question

1) Besides the traditional deposit-taking and credit-offering functions, what additional services are provided by banks in your country:

Services for depositors like:

- **Credit cards services, paying bills for depositors**
- **Consumer loans [auto, personal, bill paying, etc]**
- **Mortgages**
- **Life insurance**
- **Financial advisors; Management of investment funds; Asset management**

Services for firms like:

- **Banking services for firms (business liquidity loans, capital investment loans)**
- **Brokerage services**
- **Corporate banking services**
- **Investment banking (Stock Exchange listing, trading, clearing and settlement services)**

Answer

Article 2 of the 1990 Banking Law (BL), establishes banks and development banks as the only authorized deposit-taking and credit-granting institutions in Mexico. This questionnaire focuses on the former institutions.

In addition to these two services, banks are allowed to offer the following services:[2] issuing bank bonds and subordinate obligations; open deposits in foreign banks and financial entities; grant discounts on credits and loans; issue credit cards; accept third party credit obligations by granting credit title acceptances, endorsements, and by issuing letters of credit; operate in securities, in accordance with the Law for the Securities Market; underwrite and keep firms' stock; operate on their own with commercial documents; undertake money market operations, including repurchase agreements (repos), by their own account or on behalf of others; offer safe custody services; undertake trust operations in accordance with the General Law of Credit Titles and Operations; undertake appraisals and leasing and financial leasing activities; undertake financial factoring activities as well as other analogues or connected activities requiring the authorization by SHCP after hearing the opinion of Banxico and CNBV.[3]

Relevant financial markets where banking institutions participate include the following:[4]

On sight deposits: checking, savings and master accounts

- Term deposits
- Bank bonds
- Interbank loans
- Savings accounts

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[2] LIC Article 46.

[3] The CNBV has a public registry of all banking institutions it supervises, available in its website: http://www.cnbv.gob.mx/frame.asp?noticia_liga=si&com_id=0&sec_id=135&it_id=688

[4] García Rocha, Adalberto, 2004, "La Competencia en los Mercados Financieros", *Competencia Económica en México*, chapter 7, p. 264.

- Commercial loans to companies and persons involved in entrepreneurial activities
- Credit to financial intermediaries
- Mortgage loans
- Consumer credit
- Credit card services
- Government credit
- Fiduciary services (mandates to administer assets)
- Money market operations
- Investment Societies (cannot invest directly bust must do so through a subsidiary)
- Debt (acquisition of credit instruments)
- Voluntary pensions (cannot invest directly bust must do so through a subsidiary)
- Money brokerage (buying and selling liquid credit titles including government titles. Excludes include stock market operations)

Question

2) **With respect to the list of financial services contained in 1) are there regulatory limitations that constrain the ability of banks to offer some of them? Are there regulatory limits on the ability of banks to lend?**

Answer

While multiple banking firms cannot offer all financial services, the fact that they generally belong to a Financial Group (FG) allows their clients to have access to an integrated service.[5] This corporate arrangement also lets banks benefit from the sharing of client information, infrastructure, and allows them to offer joint services to the public with other companies belonging to the same group.[6] However, Mexican law restricts each financial entity belonging to a FG to only engage in those activities for which it has an express authorization.

There are regulatory lending limits on banks. Credit institutions must observe the following table when lending to an individual, corporation or group that can be considered as one because of their common risk.[7]

Capitalization level	Lending maximum limit (calculated on the basic capital of the credit institution concerned)
More than 8% and up to 9%	12%
More than 9% and up to 10%	15%
More than 10% and up to 12%	25%
More than 12% and up to 15%	30%
More than 15%	40%

Question

3) **Considering each service as detailed in question 1), please provide a brief description of the market structure, considering that for most of these services banks compete also with non banks and that if the size of the market is local you should provide some sort of nation-wide averages:**

[5] According to the 1990 Law of Financial Groups, these must include at least two different types of the following financial intermediaries: multiple banking institutions, brokerage houses, or securities institutions.

[6] Article 8 of the Law of Financial Groups explicitly allows financial entities of the same group to perform these joint activities.

[7] General Rules for Risk Diversification Over Active and Passive Operations of Credit Institutions. Published by the CNBV on April 30th, 2003 in the Federal Official Daily Gazette.

Answer

Until 2001, the Mexican financial system comprised 28 financial groups, 56 commercial banks, 381 institutions belonging to the securities market, and 460 institutions classified as other financial intermediaries and credit information companies.

Commercial banks are corporations whose equity may be sold in the stock exchange. All banks can open up offices and do business anywhere in the country. It is highly concentrated, with the two largest banks (Banamex-Citibank and BBVA-Bancomer) concentrating more than 50% of the market as measured by assets or deposits. About one quarter of all banks control almost all retail operations.[8]

There are approximately 8 million credit cards and 33 million debit cards outstanding. Three interconnected networks with national coverage offer ATM services. Two of these networks are property of the two largest banks, Banamex-Citibank and BBVA-Bancomer; the remaining network is controlled by PROSA, a company owned by 24 other banks. Visa and MasterCard are the principal operators of debit and credit cards, although American Express and, on a smaller scale, Diners, offer credit cards.[9]

(j) is there a single provider for each product? Are there a few large providers? Are there many providers?

Answer

Banking resources amount to 2.17 billion pesos (192 million USD) in November 2004. The banking portion of liabilities included in the monetary base was 27% in 1997, compared to 76% in OECD countries. Banking credit to the private sector in 1997 was 16% a rather low level compared to Brazil (30%) or Chile (89%).[10]

In some cases banking and non banking institutions (e.g. savings and loans, credit unions, Sofoles, car financing, commercial and department stores credit) coincide in offering savings and credit services. Sofoles, for example, have an important presence in mortgage financing and the Commission includes them in the measurement of market size and participation in merger analysis. In the case of fiduciary services, banks compete with other financial institutions, in particular with development banks. In investment banking services they participate in the market along with investment societies and brokerage firms. In money operations, which include brokerage operations (government certificates, promissory notes, bank bonds and futures) they compete alongside brokerage firms.

Remittances from Mexicans living abroad (mainly the US) are generally processed by US companies such as Money Gram and Western Union in collaboration with local partners, usually banks but also competing retailers.[11]

(k) Is there one single consumer of the product considered? Are there a few large entities as major consumers? Are there many consumers?

Answer

There are a few large entities that can be characterized as major consumers. Consumers of formal financial services are few relative to other OECD member countries. For example, financial penetration as a component of M4 is low relative to the size of the economy 50% as a percentage of GDP.[12] Furthermore, financial deepening for basic services such as savings and checking accounts as well as credit cards is markedly different for high and low income consumers: between 58 to

[8] *Payments and Securities Clearance and Settlement Systems in Mexico*, March 2003, Western Hemisphere Payments and Securities Clearance and Settlements Initiative. Centre for Latin American Monetary Studies, The World Bank, p. 20. (Hereafter World Bank Report).

[9] World Bank Report, pp. 9-13 and 21-22.

[10] García Rocha pp. 258-259 and Annual Report Banxico 2003.

[11] World Bank Report March 2003, p. 13.

[12] García Rocha, pp. 258-259.

71% of families have access to these services in the former case while only 8% have access in the latter.[13]

(l) In geographic terms, how wide is the market for the products concerned?
[are customers' branch/location dependent? What is the willingness of customer to use distant branches?]

Answer

Although concessions authorize financial institutions to operate nationally, in practice the geographic dimension of their services is regional. In the case of major consumers, geographic dimension can also be international as these players have access to foreign sources of funds.[14]

Question

4) Please briefly describe the paperwork required to switch bank for a depositor and whether there are fees (how high?) that banks require to close an account
[what are the fees associated? What are the fees for opening an account, minimum balances, fees for closing an account]

Answer

Basic requirements to open a bank account include: request form, official identification with picture, proof of residence, and a minimum opening deposit. There are no fees for closing an account, however, anecdotal evidence suggests that there is significant red tape associated with switching: depositors must, at some point, incur the costs of two open accounts; if these are credit card accounts, the closing of one account does not guarantee that credit will be granted through a different card. In the case of businesses affiliated with a given credit card provider, if they wish to end their relationship with the credit card company, they must keep their account open with this company, in some cases, for at least six months before it can be closed.

Question

5) Is access of bank financing by the business sector based on:
a) collateral guarantees (*i.e.* real estate)?
b) political patronage?
c) nature/size/length of time of existence of the firm?
d) accurate risk assessment of the project to be financed?

Answer

Requirements to have access to bank financing and depends on the type of credit requested and the bank. Each bank sets its own policies regarding bank financing, the collateral it requires and the assessment for the project requiring financing. According to CONDUSEF's comparison tables for financial services, bank financing is mainly based on collateral guarantees, such as: a backer or a person providing a surety; real estate; on sight deposits; a percentage of the nominal value of documents such as promissory notes, counter receipts, exchange letters or appraisals of a project under execution, goods acquired with the loan, mortgage or fiduciary guarantees.

[13] 1998 Information for Mexico City from BIMSA's methodological book.
[14] García Rocha, pp. 264-65.

Question

6) What is the importance of the informal non institutional sector (families, friends etc.) for providing credit to the business sector, especially to smaller firms?

Answer

From 1995 to date banking credit has been extremely scarce, and financing has not taken place through the bonds market but rather through foreign markets and other non-banking sources, such as supplier's credit or trade credit. In a study by Banxico, researchers used information from trade credit by company to estimate the effect that interest rates have had on such credit. They found that suppliers' credit behaved in an opposite manner to banking credit, which implies that it is an imperfect substitute of the latter. However, this result does not apply to Mexico during the period 1996-1999. This could potentially indicate that for this period trade credit was a complement of banking credit.[15]

Another measure of the importance of informal, non-institutional financial credit can be gauged by analyzing the financial requirements of micro-businesses. Micro-businesses in Mexico are defined as economic units (firms) of up to 6 persons, including the owner and workers (who may receive payment or not) in the following activities: construction, commerce, services, transport, and manufacturing.[16] They have been periodically surveyed by the INEGI (National Institute of Statistics, Geography and Information) every two years since 1992 through the National Survey of Micro-businesses.[17] SEDESOL'S social programs of loans to the extremely poor provides an alternative measure of the size and importance of informal credit institutions. The programs are part of the National Development Plan prepared by the Federal Government for the period 2001-2006 and consist of the following: "credit on your word", "social credit", "productivity credits for women", "entrepreneurial training", "saving with you", "productive integration", and local development agencies. The average size of credits is about USD$55 and totaled $287,116,057 pesos ($25.4 million US dollars) in 2004.

Based on the 2002 National Survey of Micro-businesses, 3.4 million firms out of a total 4.4 million surveyed replied that they had required initial financing. Those businesses that did not require financing stated as reasons the fact that they had inherited the business (10.4%), or that their business did not require additional investments (80.3%). Informal sources of financing for firms requiring initial investments included funds from: personal savings (65.3%), friends or relatives (19.1%), previous job's liquidation (7.4%), other sources (2.2%), private moneylenders (2.1%), suppliers (1.7%), and customers (0.3%). Formal financing represented less than 2% of funds: banking institutions (0.5%), government programs (0.2%), and non-banking popular savings (1%).

Based on this survey, about 380,000 micro-businesses had recent credit requests. The share of these credit requests was divided among the following parties: friends or relatives (40.1%), non-banking popular savings and private moneylenders (30.0%), banking institutions (11.0%), government programs (7.4%), other sources (6.1%), credit unions and other financial societies (3.8%), and development banks (1.6%).

Loans to micro-businesses amounted to $8,680 million pesos (USD $852.5 million) the amounts granted by each party were: friends and family (non-interest bearing) $3,515 million pesos (USD $345.22 million), commercial banks $2,380 million pesos (USD $233.75 million), other sources $984 million pesos (USD $96.64 million), development banks $887 million pesos (USD $87.12 million), credit unions and other savings and loans financial institutions $689 million pesos (USD $67.67 million), and government programs $224 million pesos (USD $22 million).

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[15] From Martínez, Lorenza, Oscar Sánchez and Alejandro Werner, 2000, "Monetary policy and transmission Mechanism in Mexico" in *Stabilization and Monetary Policy: The International Experience*, Banco de México, November 2000.

[16] Economic units for the manufacturing sector consist of up to 16 persons.

[17] The time elapsed between the last two surveys, however, was four years.

Question

7) **Does lender have access to customer credit report from reporting agency (Equifax, etc)?**

Answer

The Mexican credit bureau was established in 1996. Among its main purposes is to gather information about credit behavior of firms and individuals that may be relevant to credit granting agencies when determining creditworthiness. According to article 2 of the LRSIC, users of the bureau are financial entities and commercial companies that provide information or make inquiries to society in general. Institutions that regulate the Credit Bureau are SHCP, Banco de México, CNBV and CONDUSEF.

To establish a SIC, authorization is required from SHCP, attending to the opinion of Banco de México and the CNBV; this authorization cannot be transferred. At present the bureau consists of two Credit Information Societies (SIC's):[18] (1) Trans Union de México, SA, a credit bureau providing credit information for 27 million individuals, which was first authorized in 1996, and (2) Dun & Bradstreet de México, SA, a credit bureau providing information on the credit behavior of 1 million firms and persons undertaking business activities, which was incorporated in 1998. Banks have a 70% ownership stake in each of these SIC's and are also their main clients.

In a written consultation by a third party, the Federal Competition Commission considered that these SIC's could not be considered competitors and that that if an analysis were undertaken, they could potentially be regarded as economic agents with substantial market power, in accordance with article 13 of the LFCE.[19]

Credit information in the bureau is provided by credit grantors and kept in individual records. There are two types of information provided: (1) outstanding credits and (2) credits that have been paid in their entirety. The information is updated on a monthly basis by the bureau and is available for consultation to societies that have contracted these services: banks, credit card issuers, mortgage companies, credit financing companies, department stores, commercial companies and communication services companies. Two types of reports are available: the Credit Report, which omits information on the financial entities or creditors of the firm or individual, and the Special Credit Report, which contains all information in the credit record of said individual or firm. Requests for a Credit Report require *written authorization* from a client. Any individual or firm can request a free copy of his Special Credit Report once a year through specialized units of SIC's, more frequent consultations of the Special Credit Report are subject to a charge (between $5 and $10 US dollars, depending on the delivery service requested).

- **How transparent are business financial statements – e.g. bank more likely to lend to publicly traded company because more financial information is available?**

Answer

Publicly traded companies must comply with GAAP's (Generally Accepted Accounting Principles), which ensure that they provide basic accounting information that is comparable across similarly situated firms. However, the number of publicly traded firms in Mexico is relatively small and banks do not limit their services to these.

The National Survey of Micro-businesses does provide some indication that banks restrict their offering of credit and loans to those businesses that keep relatively basic accounting records or whose records are non-existent (see answer to question 6).

- **Does the regulator collect and provide to all banks an up to date register of all major debtors in the country (with a precise indication of the risk associated with**

[18] Equifax began operations in 1996 but closed in 2000.

[19] CON-02-2004. For further details refer to section V of this questionnaire.

each debtor), so that also a new entrant in banking can provide credit to local entrepreneurs?

Answer

Information on debtors' solvency is generally held in exclusivity by banks and serves as a potential barrier to entry into the credit market.[20] Until 1995, Banco de México had a service that functioned as a credit bureau and provided regular credit reports to banks upon request. Banxico still collects this information but only provides it to banks upon request and for a given individual or company; it does not provide a list of major debtors.

- **Is the information costly? Timely? Reliable?**

Answer

See previous answer.

- **How do banks measure risk of borrower?**

Answer

Credit portfolios are graded according to SHCP rules and CNBV methodologies. In the case of commercial or mortgage housing portfolios, CNBV authorizes an internal methodology for grading. Through its circular 1480 (October 2000), the CNBV established a new methodology that follows internationally accepted practices for commercial banks to grade commercial loans, and also establishes preventive reserves. Alternative methodologies for grading commercial loans portfolios can be used with the prior authorization of CNBV. This authorization is valid for two years and can be suspended at all times if the CNBV determines that the methodology used does not meet applicable dispositions, is obsolete, or inadequately reflects the credit of the commercial loan portfolio.

Question

8) **In general do the official accounts of business firms provide a clear picture of their credit worthiness or do companies regularly have a double set of accounts (one for fiscal and one for company management purposes)?**

Answer

Unknown.

Question

9) **In the case of a non performing loan what are the options open to a bank (selling the collateral, suing the debtor, asking for government relief, etc.)? In the answer please provide some indication on the timing of each procedure and on the costs involved.**

Answer

In 2002 the Bankruptcy Law changed allowing for a more speedy recovery of loans (prior to the reform it was estimated that loan recovery took between 6 and 10 years). Nonetheless, it is estimated that very few companies comply with the law and the enforcement of the law, which involves the judicial branch and can be appealed through various instances and judgments, continues to be slow and inefficient.

[20] García Rocha, pp. 264-265.

Question

10) Do businesses in general have a credit relationship with only one bank or is the phenomenon of multi banks credit widespread?

Answer

Relationship financing is widespread. Academic studies have argued that members of boards of directors, especially members of the boards of banks, are more likely to receive credit from banks.[21] Anecdotal evidence also suggests that this phenomenon is important, as financial groups tend to have close relations with some of the most important industrial groups in the country.

Sector-specific regulation in banking: Institutional setting

Question

11) Please describe the institutional structure of banking regulation in your country. What body/agency is responsible for bank regulation? Is there more than one regulatory agency (such as a "Banking Commission", or a "Financial Services Authority" - in some countries this role is played by the central bank)? To whom is/are it/they responsible or accountable (prime minister/finance minister/legislative body…)? What is the form of this institution, its principal functions and statutory objectives? How transparent is its decision making? Are its decisions published? What discretion does it have? How does it exercise that discretion? Etc.

Answer

The legal framework for the banking industry in Mexico is determined by the following laws: the 1990 Banking Law (LIC) and the 1990 Law Regulating Financial Groups (LRAF). The former law's purpose is to regulate bank and credit services, the organization and operation of credit institutions and any activities that they might develop. Other LIC objectives are to ensure the healthy and balanced development of credit institutions, to safeguard the public's interests, and to determine the terms under which the State will exercise its financial guidance.[22] The LRAF's main purpose is to regulate the organization and operation of financial groups, establish guidelines under which they should operate, and protect the interests of those who do business with these groups.[23]
The LIC sets out the legal framework for the capital structure and operations of the banking system. The LFG allows a single holding company to carry out separate commercial banking, brokerage, and other financial activities; banks generally head financial groups and dominate the Mexican financial system. Other rules governing the operations of financial entities are the Circulars of Banco de México and those of the National Banking and Exchange Commission (CNBV).
Seven agencies are in charge of regulating financial services: SHCP, Banxico, CNBV, IPAB, CONDUSEF, CONSAR, and CNSF. The first four regulate banking services in particular, the fifth regulator defends the rights of financial services users. The remaining two regulators oversee financial services where banks cannot participate: the savings for retirement system, and insurance and guarantees. The relationship between these institutions in the case of the banking system can be broadly characterized as follows: SHCP is in charge of designing the rules, Banxico must make

[21] See for example, del Ángel, Gustavo and Carlos Marichal (2003) "Poder y Crisis. Historiografía Reciente de la Banca Mexicana", *Historia Mexicana*, no. 207 (January-March), and La Porta, Rafael, Florencio Lopez de Silanes, and Guillermo Zamarripa, "Related Lending" (May 16, 2002). Yale ICF Working Paper No. 02-19.
[22] Source
[23] Source

these rules operational, and CNBV is in charge of supervising their compliance. Coordination among these agencies takes place but is not transparent and they have ample room for discretion (although less so than in the past) in granting authorization to parties' applications (in fact, they are not obliged to publish authorization requests unless their outcome is positive and can decline authorization alleging reasons such as "absence of moral authority").

All agencies are subject to the Federal Law for Transparency and Access to Public Government Information (LFTAIPG) and the Law for Transparency and Ordinance of Financial Services (LTOSF). According to the former, any agency subject to this law must publish in their website and, in general, give access to 17 different types of information which include: organic structure, faculties, address book for civil servants and their monthly earnings, address for information requests, goals and objectives, services offered, formats, requisites and proceedings, information on their assigned budget and its use, results from audits, concessions, contracting, etc.

More detailed information on each agency's duties follows:

Ministry of Finance and Public Credit (SHCP)

The SHCP determines major regulations to which the financial system is subject. Regulatory agencies under its umbrella have regulatory and supervisory powers over the types of financial institutions in which they specialize.

Central Bank of Mexico (Banco de México)

The Central Bank, as established under paragraphs six and seven of the Political Constitution of the United Mexican States, is a legal entity subject to public law and autonomous in nature. Its purpose is to provide the country's economy with domestic currency, and its primary objective is to seek the stability of the peso's purchasing power. It operates with credit institutions as the reserve bank and lender of last resort. Banco de México is also in charge of promoting the sound development of the financial system and of fostering the proper functioning of the payments system, imposing sanctions on entities that do not follow its dispositions.

Banco de México establishes the operational rules under which intermediaries participate in the market for government securities, the broader money market, the foreign exchange and derivatives market, and the payment systems. It also regulates the transfer of funds through credit institutions.[24]

Since 2000, the Bank publishes reports every trimester on inflation, containing detailed information on its evolution as well as the main factors that have influence on it. In addition, it publishes an annual evaluation of the economic environment on which the monetary policy is based. Since January 2003, the Bank makes public its decisions, which are published on pre-established dates.

National Banking and Exchange Commission (CNBV)

The CNBV is a decentralized organ of the SHCP with technical autonomy and executive powers. Its mandate is to "supervise and regulate, within its field of competition, the financial entities so as to secure their stability and correct operation, and to maintain and foster the healthy and balanced development of the financial system as a whole, in the protection of the public's interests". Its mandate extends beyond the banking system (which includes development banks), to the supervision of exchange markets as well as those institutions offering factoring, financial leasing, and custody operations services. It is also responsible for overseeing brokerage houses, credit unions, and saving and loans associations.

The CNBV has the power to issue prudential rules that ensure liquidity, solvency and stability among intermediaries, including rules on risk diversification, preventive provisions and minimum capital requirements. It can intervene in institutions with the purpose of suspending, normalizing or solving operations that could endanger their solvency, stability or liquidity, or if these operations are unlawful. It can also investigate actions of individuals or corporations considered to violate laws applicable to financial entities, order inspections and suspend operations.[25]

Regarding transparency, the CNBV publishes circulars on its website. Proposed circulars are also published for a period of 30 days as a link to the draft circulars it submits to COFEMER, in charge

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[24] Articles 2, 3, 15, 24 and 31 of the 1993 Central Bank Law.

[25] World Bank, Mexico Report, pp. 26-28.

of undertaking a regulatory impact assessment. Parties can make consultations or submit opinions regarding the draft circulars during this period.

Institute for the Protection of Bank Savings (IPAB)

In Mexico, the first formal deposit insurance scheme was created in 1990: FOBAPROA. This was a trust whose trustee was Banco de México, whose grantor was the SHCP and whose beneficiaries were banking institutions. All banks had an obligation to participate in it and the system covered all financial liabilities. After the banking bail out of 1995, Congress enacted the Law for the Protection of Bank Savings (LPAB) in 1998, which created IPAB.

IPAB is part of the network of financial security of the Mexican financial system and is responsible, in coordination with other Mexican authorities, to follow up and define the situation of insolvent banks and, in a given case, sell off its assets to pay for its guaranteed obligations. This network favors financial system stability and is made up of the Ministry of SHCP, CNVB, Banco de México and IPAB.

IPAB is a decentralized organ of the federal government with two main purposes: (a) to establish a system for protection of savings in banks, and (b) to manage the financial recovery programs it may create in order to protect bank depositors and clients. It has the power to perform preventive interventions and can manage and sell assets of banks that have been intervened by the authorities. IPAB also determines ordinary or extraordinary fees that banks are required to pay in order to build the fund. Although at present the system charges uniform percentages (0.4% of each bank's total liabilities), the law provides for the creation of a system where fees are determined by individual bank risk. IPAB is required to publish every three months the amount paid by each institution.

Starting 2003, deposit insurance provided by IPAB is limited and by 2006 it will establish a maximum coverage per person (either individuals or corporations) of approximately USD$120,000. Banking liabilities guaranteed by IPAB are also limited: it does not cover liabilities with other financial institutions belonging to the same financial group, or any liabilities or deposits of shareholders, board members and officers of the bank (first two levels in the hierarchy). Only operations that comply with legal, regulatory and administrative dispositions or best market practices are covered.[26]

Currently, there are 33 banks that receive deposit insurance coverage protection from IPAB. IPAB does not protect investments in the following financial institutions: insurance companies, investment societies, credit unions, savings and loans, brokerage houses and development banks.

National Commission for the Protection and Defense of Financial Services Users (CONDUSEF)

CONDUSEF, an organ of the SHCP, is a public decentralized agency with autonomy in its decision-making. Its object is to promote, advise, protect and defend the rights and interest of financial services users in order to create and foster an adequate culture among users, regarding financial operations and services. For this purpose, on a regular basis it publishes reports on the different types of services, fees, rights and obligations of providers and consumers of financial services. It disseminates through its website information that can be useful for potential users of services such as credit simulators, comparison tables for fees and services, and references on services' reliability, among other information.

It also provides legal advice to users of financial services, acts as an impartial referee in relations between clients and financial institutions, as an arbiter in proceedings "under a friendly composition and as a strict matter of law", and can render technical opinions pursuant to its own law (LPDUSF).[27] To fulfill its duties, article 82 of the LPDUSF provides that CONDUSEF may impose penalties and solicit public force aid.

National Commission of the System of Savings for Retirement (CONSAR)

National Commission for Insurance and Securities (CNSF)

[26] World Bank, Mexico Report, pp. 29-30.

[27] http://www.condusef.gob.mx/ingles/law.htm

Sector-specific regulation in banking: Structural regulation

Question

12) Can you describe the rules on branching and new entry in your country?

Answer

New entrants require the authorization of SHCP, who evaluates a business plan among other considerations. Once an authorization is secured, there are no restrictions for the establishment of branches since banking regulation has a federal character.

Question

13) Is the entry of foreign banks specifically regulated? Are there restrictions to their operations in your country, both in terms of market size and of services offered? Once foreign banks have entered the domestic market, are they subject to rules different than those applying to national banks?

Answer

Foreign capital was traditionally banned from domestic credit institutions. Laws were relaxed in the early 1990s, and by 1994 participation of foreign capital in the Mexican financial sector increased progressively as entry barriers in most markets were lowered following legal amendments of trade agreements which Mexico signed with its NAFTA partners. With the entry into force of NAFTA, Canadian and United States financial institutions were allowed to participate through affiliates. In 1995, financial institutions were allowed to hold 25 percent aggregate market share in the ownership of financial groups. Capital requirements also changed, allowing foreign ownership in a bank's capital to increase to 49 percent. By 1998 all remaining restrictions on foreign shares in Mexican financial institutions were eliminated. This year 76 percent of the banking system was in the hands of foreign capital, with Citigroup's acquisition of Banamex in 2001, almost 90 percent of the banking system's assets is owned by foreign institutions. Some limits to foreign participation still remain: foreign banks, for example, are not allowed to establish branches directly and must do so by first establishing an affiliate, which is subject to authorizations and regulations.

Question

14) In the case of financial investments into a bank capital (by other banks or by non banks) are the principles of safety and prudence exactly defined (either by the law or by the regulator) so that an investor can anticipate the likely response? How much discretion does the regulator have? How has it been used?

Answer

Banxico establishes minimum capital requirements not subject to discretion.

Question

15) Is the expansion of banks regulated? Are there explicit limits to its geographical concentration? Is there regulatory supervision on the opening of new branches?

Answer

There are no explicit limits to geographical concentration nor is there regulatory supervision on the opening of new branches (see answer to question 12).

Question

16) Are there regulatory restrictions on pricing (interest rate controls and other control on prices and fees)?

Answer

Interest rate controls were eliminated in 1989, prior to the privatization of banks.

The LTOSF, enacted in January 2004, regulates commissions, inter-bank fees and other ancillary services for financial institutions banks, including payment systems through the Central Bank. The law determines who can set commissions and requires that these be transparent to the user; it defines as discriminatory practices the charging of differential commissions to clients, consumers that are not clients of the credit institution, and barring clients from obtaining services from other financial institutions or networks. The law establishes minimum information requirements for financial statements and establishes sanctions.

The LTOSF also requires financial entities to notify Banco de México of any changes to their commissions two days before they become effective. To date the Bank has authorized all changes to commissions but is expected to issue guidelines on how it will evaluate the rationale behind fee setting or any changes to commissions, as high commission fees and prices are currently an item of debate in Mexican society.

- **How are they administered?**

Answer

See previous answer

- **Are there restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements not to hold other securities; including requirements not to hold the control of non financial companies)?**

Answer

Commercial banks may invest in the capital stock of investment companies and their managing companies, pension funds and their managing companies, and in credit and auxiliary institutions that do not belong to a financial group. These investments, however, may not exceed (1) the surplus over the minimum capital of paid-in capital plus capital reserves, or (2) 50 per cent of the paid-in capital and capital reserves. There is also an individual shareholding limit for banks of five per cent of their capital stock (20 per cent, with prior authorization by the SHCP).

Investments in real estate may not exceed 60 per cent of the paid-in capital plus reserves of the bank. The total amount of investments made in financial institutions plus real-estate investments may not exceed paid-in capital plus capital reserves.

Commercial banks may invest in non-financial corporations up to 5 percent of the paid-in capital of the issuer, and a higher percentage requires the authorization of SHCP. Total investments in non-financial corporations may not exceed 5 percent of banks' deposits in the domestic market. Commercial banks may only invest in limited liability corporations.[28]

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[28] Contribution by Mexico, pp. 148-9 DAFFE/CLP(98)16.

Question

17) Are there requirements to direct credit to favored sectors and enterprises?

Answer

There are no requirements to direct credit to favored sectors and enterprises; preferential credit is only granted through development banks.[29]

Question

18) Besides the formal statutory regime, are there any understandings or expectations about the actions of, say, the central bank (such as "lender of last resort" or "too big to fail") or other government agencies which could affect the behaviour of banks?

Answer

Until 1999 there was an implicit understanding that all deposits would be covered, with the creation of IPAB deposit insurance will be capped. Further information can be found in question 11).

Competition Regulation in banking

Question

19) Please describe the application of the national competition law to the banking sector. Are there any exemptions to the application of the national competition law that apply to banks? Are banks subject to the general competition law or to specific competition rules (i.e., are there special provisions relating to bank mergers, inter-bank agreements, and so on)?

Answer

Banks are not exempted from the application of the competition law. According to article 3 of the Federal Law of Economic Competition (LFCE) applies to all economic agents, "whether individuals or corporations, agencies or entities of the federal, state or local administration, associations, professional groups, trusts or any other form of participation in economic activities". Article 4 specifies that only areas regarded as strategic under the Mexican Constitution will not constitute monopolies, this, however, does not exempt their behavior from being deemed anticompetitive. According to article 28 of the Mexican Constitution, strategic areas include: postal services; telegraphs and radio telegraphy; petroleum and other hydrocarbons; basic petrochemicals; radioactive minerals and generation of nuclear energy; electric power; and currency emission functions of the central bank.

The LIC also contains certain rules regarding mergers. Article 27 of this law states that any merger between two or more banking institutions requires the approval of the SHCP, which will consult Banxico and the CNBV. With the exception of the Savings for Retirement System Law (LSAR), laws regulating each financial service make no explicit mention of competition aspects in each of these services.[30]

The competition law defines mergers (or concentrations) as "the merger, acquisition of control or any other action through which corporations, associations, stocks, equity interest, trusts and assets in general are carried out amongst competitors, suppliers, customers or any other economic agents."

[29] Contribution by Mexico, pp. 148-9 DAFFE/CLP(98)16.

[30] García Rocha, p. 263

Under this definition, some inter-bank agreements can be typified as a concentration.[31] This same article states that "[t]he Commission shall challenge and sanction those concentrations whose object or effect is to diminish, damage or deter competition and free market access to equal, similar or substantially related goods and services."
As long as the value of the transaction reaches any of the thresholds specified under article 20 of the LFCE, a merger must be notified to the competition authority prior to its completion.[32]

- **If the latter is the case, are these sector-specific competition rules more restrictive or less restrictive than the national competition laws?**

Answer

Does not apply

- **What was the public policy reason behind sector-specific competition rules?**

Answer

Does not apply

Question

20) Who enforces the competition laws in the banking sector? Is it the sole responsibility of the national competition authority? If not, is the responsibility shared with another agency, or solely the responsibility of another agency? Does this other agency also deal with prudential regulation? If the responsibility is shared, how is it shared? (i.e., are some components of competition law, such

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[31] Article 16 of the LFCE.

[32] Article 20 of the LFCE reads as follows:

"The Commission should be notified of the following concentrations, before they are made:

I. If the value of a transaction or a series of transactions is equal to or higher than 12 million times the general minimum wage in effect for the Federal district [currently $542.8 million pesos (USD$48 million)]*;*

II. If a transaction or a series of transactions implies the accumulation of 35 per cent or more of the assets or shares of an economic agent whose assets or sales amount to more than 12 million times the general minimum wage in effect in the Federal District; or

III. If two or more economic agents participate in the transaction, and their assets or annual volume of sales, jointly or separately add up to more than 48 million times the general minimum wage m effect m the Federal District [currently $2,171.52 million pesos (USD$192.17 million)]*, and that transaction implies an additional accumulation of assets and capital stock in excess of four million eight hundred thousand times the general minimum wage in effect in the Federal District* [currently $217.15 million pesos (USD$19.22 million)].

In order to register those acts, which by their nature should be registered in the Public Trade Registry, the economic agents under items I and III should credit that they have obtained favourable resolutions from the Commission or that they have given the notification mentioned in this Article without the Commission issuing a resolution in the term established in the following article."

Mergers must be notified in the time and manner set out under article 17 of the Rulings of the LFCE:

"The notification of the concentrations referred to under the terms of Article 20 of the Law must be made before any of the following possible events take place:

I. The legal act is completed in accordance with the applicable legislation or, should it be the case, the precedent condition to which this act is subject to, is fulfilled;

II. Control is acquired de facto or de jure, or exercised directly or indirectly over another economic agent; or before assets, participation in trusts, partners' capital contributions or shares of another economic agent are acquired de facto or de jure;

III. A merger agreement is signed between the economic agents involved, or

IV. In the case of a succession of acts, before executing that which, when completed, would result in exceeding the amounts laid down in said Article.

In the case of concentrations resulting from legal acts carried out in other countries, these must be notified before they have legal or material effects in Mexican national territory.

as horizontal agreements, the responsibility of one agency and other components, such as the regulation of mergers, the responsibility of another?) Does one agency have a veto over another, or consensus is required? If another agency has sole responsibility for all or part of the competition laws in the banking sector, does the national competition authority have the right to provide advice? Has it ever done so? How was it valued by the regulatory agency? Please comment on the decisions taken by this other agency, from a competition perspective.

Answer

The LFCE, in force since 1993, fully applies to the banking sector. Specific banking legislation does not contain dispositions on competition nor establishes specific responsibilities of the sectoral regulator to enhance and protect competition, but only to promote a healthy market development. Hence, under the legal framework, competition and banking authorities act in a coordinated manner. Regarding mergers, both the LFCE and the LIC establish controls and require prior notification of the transaction. Under article 20 of the LFCE, merging parties must notify concentrations that surpass certain thresholds. Pursuant to article 27 of the LIC, any merger between two or more banking institutions requires approval by SHCP, which in turn will consult Banco de México and the CNBV. The CFC may require information from financial authorities, but the analysis and resolution are independent of their decisions. The CFC does not have veto over the CNBV's decisions or viceversa. Moreover, the CFC's resolutions on banking concentrations, and financial concentrations in general, include a disclaimer aimed at making the merging parties aware that the CFC's decision refers to competition matters only and does not prejudge other authorities' decisions.

Question

21) Please comment on particular actions taken by the competition authority:

(a) In the case of mergers, what has been the approach of the competition authority to market definition? Which separate markets were identified, why? Have you treated banks as offering a bundle of services to each customer or as offering a multi-product range, with different markets for each product? What was the geographic scope of each market? Has the Internet or telephone banking appreciably affected questions of market definition? Was the informal sector considered in the antitrust analysis of bank behavior?

Answer

BBV / Bancomer[33]

On April 2000, Grupo Financiero BBV-Probursa (BBV) and Grupo Financiero Bancomer (Bancomer) notified their intention to merge the whole range of their activities in Mexico. As part of the operation Banco Bilbao Vizcaya Argentaria, SA (BBVA) would sell its direct and indirect holdings in the pension fund administrator *Profuturo GNP Afore*. BBVA is one of the largest financial groups in Spain and at the time of the notification, Bancomer was the second largest financial institution in Mexico, behind Banamex; the merger would make this the largest financial group in the country.

The Commission evaluated the following markets: banking, investment societies and brokerage houses, insurance and pension funds administrators (Afores). Banking services that were assessed included on-sight deposits, term deposits, bank bonds, interbank loans, savings accounts, commercial loans, loans to financial intermediaries, mortgage loans, consumer credit (via credit cards), government loans, fiduciary services, and foreign exchange market. Additional markets reviewed included those involving investment societies, the money and

[33] CNT-54-2000.

stock markets, insurance and Afores. The geographic dimension in all cases was national, although regional-level concentration of bank branches was also evaluated. Concentration indices in all markets indicated that the merger complied with CFC guidelines.[34]

In the analysis of barriers to entry, the CFC considered that foreign investors could participate in financial institutions through affiliates, and only in the case of Afores were there explicit market share limits. In the case of complementary services, the Commission reviewed the agents' participation in companies involved in the transportation, compensation, as well as liquidation of assets, data processing, credit card operations and ATM processing, and SIC's. The Commission determined that the merger did not affect control or decision-making in each of these societies.

Since both parties had an ownership stake in telecommunication companies, the CFC also undertook an analysis of these markets and determined that Bancomer participated in long distance and internet access services, while BBV participated in information services through the internet. These activities, the Commission concluded, belonged to different markets. The Commission authorized the concentration subject to the selling of BBVA's ownership titles in *Profuturo GNP Afore* over the course of one year.

Citigroup / Banamex Merger[35]

On June 2001, Citigroup Inc. (Citigroup) and Grupo Financiero Banamex SA de CV (Banacci) notified to the Commission their intention to carry out a merger comprising the whole range of their activities in Mexico. This transaction involved one of the largest international financing institutions and the second largest Mexican institution (and would again make it the largest financial institutions in the country). The CFC assessed the impact of this transaction in several markets: pension funds, consumption financing and auxiliary services for electronic payment processing. As a result of the operation Citibank's *Garante* pension fund administrator would concentrate with *Banamex-Aegon*, property of Banacci. Since market shares for each pension fund administrator are restricted to no more than 20% of the total number of registered subscribers, the Commission ordered the divestiture of one pension fund administrator to prevent a single agent from concentrating an excessive market share and to preserve competition in this market.

Credit markets for consumption were defined to include car financing, consumption through credit cards issued by banks and department stores, and credit granted by wholesalers and retailers. The CFC decided that the merged agent should withdraw from a Sofol that was jointly owned by Citigroup and Grupo Financiero Bancomer, Banacci's main competitor, and ordered Citigroup to divest its share.

Finally, auxiliary services for electronic payment processing are mainly rendered by two agents solely owned by financial institutions: Prosa and E-Global. Citigroup and Banacci had an ownership stake in each of these two firms, respectively. Considering that electronic payment systems face high entry barriers derived from regulation, the Commission ordered the divestiture of Banacci's shares in E-Global. However this condition was later appealed by Banacci, who proposed to allow the merged agent to select which technological platform it would retain. The Commission accepted the proposal and the parties agreed to withdraw from one of these firms within a year of the CFC's decision.

[34] The CFC employs two concentration indices. One is the familiar Herfindahl index (HHI); that is, the sum of the squared market shares of all the firms in the market. The second is an "index of dominance," (DI) which is calculated as the sum of the squares of each firm's share of the HHI. The CFC published criteria in the Federal Official Daily Gazette (24/07/98) establishing a non-binding "safe harbour" for combinations that increase the relevant market's HHI by less than 75 points, or that result in an HHI below 2000. A transaction is also considered unlikely to affect competition adversely if it does not cause the index of dominance to increase, or if the resulting value of the DI is less than 2500. These concentration-based indicators are not decisive, and the CFC can will also examine other factors that are relevant in determining whether the merged entity may obtain power to control price or substantially restrict competitors' access to the market.

[35] CNT-99-2001 and RA-46-2001.

Auction to allocate Grupo Financiero Serfin, SA de CV[36]

On December 2, 1999, with the prior approval of its Governing Board, the IPAB issued an auction call for the purchase of up to 100 percent of Grupo Financiero Serfin's capital stock.[37] The auction consisted of two stages: a technical and an economic evaluation. The winner would be the applicant who satisfied the technical requirements and bid the highest price. In turn, the auctioned share package would grant to the winner the majority shareholding in the firms described below, together with their subsidiaries.[38]

Firm	*Activities*	*Market position*	*Applicable legislation*
Banca Serfín	Banking: retail and corporate services	3[1/]	LIC
Operadora de Bolsa Serfin	Financial intermediation	10[2/]	LMV
Factoraje Serfín	Factoring	12[1/]	LFIF
Arrendadora Serfín	Financial and simple leasing	5[1/]	LGOAAC
Almacenadora Serfín	Warehousing, supervision, warehouse operation; bonded warehousing (payment of fiscal credit on the deferred payment of foreign trade duties); Custom services; and other related services.	10[1/]	LGOAAC and LA
Seguros Serfín Lincoln	Insurance	9[1/]	LGISMS, LGSM, and additional CNSF dispositions

[1/] The ranking corresponds to the size of the ratio of firm's assets to market assets in 1999.
[2/] The ranking corresponds to the annual turnover in 1999.

Auction rules required prospective bidders to: (i) annex the favorable opinion of the CFC to their applications; (ii) obtain SHCP's authorization to operate as holding societies under the LRAF, in order to become Filial Holding Societies,[39] or a Foreign Financial Institution; (iii) not engage in bid rigging practices.[40]

Four prospective bidders requested the CFC's favorable opinion in order to participate in the bidding process: Grupo Financiero Santander Mexicano (Santander); HSBC Bank USA and HSBC North America Inc. (HSBC); Grupo Financiero Banamex Accival (Banamex); and Citicorp, related to Citibank. Prospective bidders supply all or most of the services that Serfin does. Hence, the CFC assessed the competition effects in each of these service markets.

The product markets correspond to all services included in SHCP's authorization to each subsidiary. The geographic market was defined considering the location of competitors, determined largely by legal barriers. Market shares and concentration indexes (HHI and Dominance) were based on different criteria for each market but were calculated on a national level. These criteria did not include the number of offices (or branches in the case of banking), on-line services (i.e. services over internet or telephone), or the informal sector.[41] Each market's main features are described in the following table.

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[36] LI-25(01)-99.

[37] Under the LPAB, the divestment of intervened financial firms must take place through of a tender process. Depending on the nature or condition of sale, IPAB's Governing Board may authorize that the divestment occur through an auction. In accordance with the LPAB, Grupo Financiero Serfin's losses were applied against the positive items of its capital stock, so all shareholders lost their investment with the exception of the Hong Kong Shanghai Bank Corp. Latin America (19.9% shareholding).

[38] Information on Serfín's services market penetration were provided by this company.

[39] Holding society of a Financial Group having a Foreign Financial Institution as a shareholder.

[40] This term corresponds to foreign financial entities constituted in countries that have subscribed an international treaty or agreement that allows the establishment of affiliated subsidiaries in national territory.

[41] The information used to determine market participation was obtained from the monthly reports of statistical information issued by the CNBV. All data is for September 1999.

Product market	*Geographic market*	*Substitutes*	*Number of competitors*[1/]	*Market barriers*	*Competition indexes*
Multiple commercial banking: includes all retail[2/] and corporate[3/] banking services listed in article 46 of the LIC.	National due to legal barriers.	No substitutes for relevant services. Final users may only substitute the service supplier.	36	*Legal barriers*: societies must have a national surface address and be constituted under national laws (LIC). *Economic barriers*: Fulfill SHCP's capital thresholds, demonstrate financial solvency, and technical and administrative capacity. *Technical barriers*: A competitive market position requires communication systems (with users, authorities, and other service providers) also required administrative controls to comply with applicable legal dispositions.	Market shares based on: assets, deposits collection, bank bonds, loans, subordinated obligations, and repos. Concentration indexes satisfied the thresholds for all prospective bidders, except Banamex.
Financial intermediation: includes the trading of sureties; financial advisory services; managing pension or retirement funds; investing in AFOREs or societies specialized in retirement funds; and others.	National, due to legal barriers.		25	*Legal barriers*: the society must be registered in the National Registry of Sureties and Intermediaries; Counselors, Directors, and Major owners must obtain authorization from the CNVB after demonstrating technical and administrative capacities. *Economic barriers*: fulfill prudential capitalization criteria. *Technical barriers*: same as before.	Market shares based on: assets, turnovers, and sureties in custody. Concentration indexes satisfied the thresholds for all prospective bidders.
Financial leasing.	Metropolitan areas: agents with offices in the main metropolitan areas (Mexico City, Guadalajara and Monterrey).	Leasing and other long term credits provided by financial institutions or by suppliers of fixed assets.	38 Banamex, Santander and HSBC do not participate in this market.	*Legal barriers*: societies must obtain SHCP's authorization, and act under current legislation, which prevents specific cross transactions with subsidiaries or affiliates. *Economic barriers*: fulfill minimum capital requirements.	Market shares based on assets. Concentration indexes were satisfied
Financial factoring: includes the trade of bills and other credit documents.	International	Banking credits	24 Banamex, Citicorp and HSBC do not participate in this market.	*Legal barriers*: same as for financial leasing. *Economic barriers*: Not identified.	Market shares based on assets. Concentration indexes were satisfied
Warehousing: warehouse supervision and operation; merchandise distribution; bonded warehousing (payment of fiscal credit on deferred payment of foreign trade duties); Custom services; and value added services (packaging, preservation, and labeling).	Mexico City, the only place where Serfin participates.	Self-supply or services provided by non-financial entities.	26 Banamex, Citicorp and HSBC do not participate in this market.		Market shares based on assets. Concentration indexes were satisfied
Insurance: life, pensions (retirement), accidents and health, damages, and reassurance. Each category constitutes a relevant market. The analysis focused on pension insurance because Serfin's market shares in other categories were not significant.	National, due to the coverage of sales network.	No substitutes. Each service covers a specific risk and some are complementary.	14 Citicorp and HSBC do not participate in this pension insurance market.	*Legal barriers*: Only established institutions in Mexico are authorized by SHCP to receive copayment for sales of policies and minimum requirements for capital and reserves, but they are similar to those that apply in other jurisdictions. *Economic barriers*: financing an effective sales network to increase service penetration in an underdeveloped market.	Market shares based on direct copayments. Concentration indexes were satisfied

1/ 1998 data.
2/ Retail banking includes users (natural persons or firms) with annual incomes in the 13 to 10,000 thousand dollar range.
3/ Corporate banking includes firms with turnovers of over 10 million dollars.

In April, 2000, the CFC issued favorable opinions for all prospective bidders. Grupo Financiero Santander Mexicano won the bidding process after offering the best financial proposal. The Santander group presented an offer of 14.65 billion pesos, which was paid on May 23 following the signing of a purchase sales agreement and the transfer of equity ownership of Serfin's capital stock to Santander.[42]

(b) In the case of horizontal arrangements, have you found that features of the banking industry facilitate collusive arrangements? Have network effects and/or inter-bank agreements relating to, say, ATMs, electronic processing of transactions, payment systems or joint marketing of credit/debit cards raised competition concerns?

[42] Annual Report, IPAB (2000).

Answer

Investigation involving allegations of relative monopolistic practices in ATM services[43]

In November 2000 the Commission opened an ex-officio investigation of CCS México, SA de CV (CCS), Promoción y Operación, SA de CV (Prosa), Servicios Electrónicos Globales, SA de CV (E-Global) and the Mexican Bankers Association (ABM). CCS buys, sells, monitors and maintains ATMs. Prosa and E-Global are corporations that provide complementary or auxiliary electronic banking services through ATMs. Stockholders for Prosa and E-Global belong to the ABM, which represents the general interests of the banking industry and offers specialized technical services to its members.

The investigation had the purpose of determining whether these economic agents had incurred in relative monopolistic practices in the market for services provided by commutation systems, complementary or auxiliary processing and compensating electronic banking services undertaken through ATMs in the national territory. The practice consisted in entering into an agreement, through the ABM, which established that these agents would only allow ATMs belonging to a bank, and carried the bank's institutional logo, to interconnect to the network.

The CFC initially determined that this agreement could affect or eliminate the operations of ATMs that were administered by non-banking institutions in the relevant market. The investigation did not find sufficient elements that could prove that ABM had in fact issued instructions or forced Prosa and E-Global to comply with said agreement.

(c) Have concerns been raised about bank collusion in the wholesale markets, such as the market for government debt?

Answer

Coordinating bids in auctions for government debt[44]

In December 1993, the Commission opened an ex-officio investigation regarding possible anticompetitive practices among participants in the weekly auctions for Treasury Certificates of the Federation, carried out by Banco de Mexico. The investigation showed that in October and November of 1993, the following agents coordinated their bids in some auctions: Grupo Bursatil Mexicano, Casa de Bolsa, S.A. de C.V. (GBM), Banco Nacional de Mexico, S.A. (Banamex), Operadora de Bolsa Serfin, S.A. de C.V., Casa de Bolsa Grupo Financiero Serfin (OBSA), Probursa, S.A. de C.V., Casa de Bolsa Grupo Financiero Probursa (Probursa), and Banco Internacional, S.A., Grupo Financiero Prime Internacional (Bital).

The involved parties were able to obtain the debt certificates at a rate that was below what would have prevailed in a competitive auction. This conduct was deemed incompatible with the LFCE and the agents involved were fined.

(d) Have there been specific instances of abuse of dominance or vertical arrangements which have raised competition concerns? For example have there been instances by dominant companies requiring customers to purchase a product in order to get product customer wants?

Answer

Refusal to deal: accusation by the National Association of Exchange Centers[45]

In September 1998, National Association of Exchange Centers (association) brought charges against 17 banks for unjustified cancellation of checking accounts and their derived services. The association noted that these services were essential for them to carry out money market operations and could only be provided by banking institutions. Having found no reason that could justify the cancellation of accounts in its preliminary investigation, the CFC issued summons to the accused for alleged relative (vertical) monopolistic practices in the provision of services in the relevant

[43] IO-07-2002.

[44] IO-22-93.

[45] DE-21-98.

market.[46] The relevant market was defined as banking services relating to checking accounts, associated deposit accounts, investment accounts and safe-deposit boxes in the Mexican national territory.

According to their responses and the evidence gathered from each of the accused, the CFC divided the accused into three groups. The first group's responses indicated that it was now their institutional policy to not provide services to exchange centers. This was based on the fact that exchange *centers*, as opposed to exchange *houses*, were not subject to regulation by SHCP or CNBV and were therefore more likely to undertake riskier operations and to serve as vehicles for illicit operations. These five banks also presented Banxico's new 1997 regulations and guidelines to prevent money laundering as support for their actions. They further alleged that the cost of monitoring these operations by the banks was considerable and that exchange centers and exchange houses (which are entities belonging to a financial group) would henceforth receive differential treatment.

The second group of banks, indicated that they had no policy in place to refuse these services to exchange centers. In relevant cases, they provided evidence behind the cancellation of accounts for some of the association's members. Banks in the third group demonstrated that there was insufficient evidence that would attribute to them this responsibility. The CFC's Plenum determined that all banks in these two groups were not responsible for the alleged monopolistic practices.

Regarding the first group of banks, the Plenum determined that these banks had substantial market power, a necessary condition for relative monopolistic practices to take place,[47] and consequently ordered them to cease the practices and reinstate the accounts and related financial services. The CFC also levied a fine on each of them. The banks filed a reconsideration recourse arguing that joint market power was not contemplated by the law and that the CFC had failed to show conscious parallelism among these banks; in addition, the affected exchange centers would be able to contract these services through other banks. The CFC revoked the resolution and fines imposed.

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[46] Vertical monopolistic practices are termed relative practices in the competition law. Article 8 of the LFCE specifies that all monopolistic practices are prohibited, and article 10 characterizes relative practices in the following manner:

> *Subject to verification of articles 11, 12 and 13 of this Law, relative monopolistic practices are deemed to be those acts, contracts, agreements or combinations, whose aim or effect is to improperly displace other agents from the market, substantially hinder their access thereto, or to establish exclusive advantages in favour of one or several entities or individuals, in the following cases:*
>
> *I. Some of the economic agents that do not compete among themselves are: to set, impose or establish the exclusive distribution of goods and services, by means of the subject, geographical location, or specific periods of time, including the division, distribution or assignment of customers and suppliers; and also the obligation to not manufacture or distribute goods or services for a specific period of time or that may be specified;*
>
> *II. To set the prices or other conditions that a distributor or supplier has to abide by when marketing or distributing goods or providing services;*
>
> *III. The conditioned sale or transaction when buying, acquiring, marketing or providing other goods or additional services, normally different or that can be differentiated, or on the basis of reciprocity;*
>
> *IV. The sale or transaction subject to the condition of not using or acquiring, marketing or providing goods or services produced, processed or distributed or sold by a third party;*
>
> *V. The unilateral action based on refusing to sell or provide to specific individuals, goods or services available and normally offered to third parties;*
>
> *VI. The agreement reached among several economic agents or the invitation extended them to exert pressure against customers or suppliers, in order to discourage them from specific behaviours, to apply retaliations or force them to act in a specific manner; or*
>
> *VII. In general, all the actions that unduly damage or impair the process of competition and free access to production, processing, distribution and marketing of goods and services.*

[47] Article 11 reads as follows:

> *The following conditions have to be proven for the practices in the preceding paragraph to be deemed to violate the Law:*
>
> *I. That the party assume to be responsible has substantial power in the relevant market;*
>
> *II. That they are carried our regarding the goods or services corresponding to that relevant market.*

Question

22) Are there any other particular issues or experiences in the enforcement of competition law that you think would be of interest to other competition authorities? If so, please describe them briefly and, where relevant, provide citations to any relevant publications.

Answer

Consultation regarding SIC's[48]

In January 2004, Grupo Elektra, SA de CV (Elektra) and Elektrafin Comercial, SA de CV (Elektrafin) submitted a written consultation to the commission regarding competition conditions in the market for SIC's and the relative benefits of their potential entry into this market. The Commission considered that there were only two authorized SIC's and that each supplied a different segment of the market. 70% of each company was owned by banking institutions, which were also its main clients, hence, these agents could not be regarded as competitors. According to criteria established in the LFCE, the Commission concluded that current market conditions could lead to the conclusion that said agents had substantial market power.

On the matter of the relative benefits of Elektra's and Elektrafin's potential entry into the market for credit information services for low income users, the Commission considered that this was a positive element for a market characterized by high levels of concentration and would benefit the competition process and free market access. At the same time, it would encourage current credit providers to expand their services towards the low income segment of the market. In this consultation the Commission found no elements that could contravene the LFCE. Nevertheless, it cautioned the enquiring parties that this new company would be subject to the LFCE and, in particular, should not discriminate when offering its services.

Question

23) Have there been any important regulatory changes (relating to any of the components of the regulatory regime discussed in the previous paragraphs) in the past two years? If so, briefly describe the situation before the change and the main effects of the change.

Answer

[48] CON-02-2004.

Banking, competition and economic development – South Africa

QUESTIONS

Role of banking in financing business activity in your country

Question

1) **Besides the traditional deposit-taking and credit-offering functions, what additional services are provided by banks in your country:**

Services for depositors like:
- **Credit cards services, paying bills for depositors**
- **Consumer loans [auto, personal, bill paying, etc]**
- **Mortgages**
- **Life insurance**
- **Financial advisors; Management of investment funds; Asset management**

Services for firms like:
- **Banking services for firms (business liquidity loans, capital investment loans)**
- **Brokerage services**
- **Corporate banking services**
- **Investment banking (Stock Exchange listing, trading, clearing and settlement services)**

Answer

The banks provide all the services identified in the question. In addition they also offer debit cards for customers. These function like other cards but the cardholders must have cash available in the account to make payments.

Question

2) **With respect to the list of financial services contained in 1) are there regulatory limitations that constrain the ability of banks to offer some of them? Are there regulatory limits on the ability of banks to lend?**

Answer

There are no regulatory limitations constraining banks from offering the services referred to in question 1. However within their ordinary activities banks have to comply with various legislation, including the Banks Act; the Short Term Insurance Act; the Long Term Insurance Act and the Usury Act, etc. These statues provide for compliance by banks with the various standard reporting requirements etc. There are no regulatory limitations on the ability of banks to lend.

Question

3) **Considering each service as detailed in question 1), please provide a brief description of the market structure, considering that for most of these services banks compete also with non banks and that if the size of the market is local you should provide some sort of nation-wide averages:**

Answer

There are at least 74 banks operating in the South African Market. They are broken down into the following categories: Locally controlled registered banks (15); Foreign controlled registered banks (6); Registered branches of international banks (15); Registered mutual banks (2); Representative offices of foreign banks (15). Those that offer all of the services detailed in question 1 include locally controlled registered banks (Standard Bank, ABSA, Nedcor and First National Bank). The other banks offer specific services to specific sectors of the population e.g. high earning/upper market only or lower market only, these include Investec and African Bank respectively. Other banks also offer limited niche services to a specific market. Within this sector are micro lenders. These are lending institutions providing finance at very high interest rates. They target the lower end of the market. Capitec Bank is one of the operators in this market. Capitec Bank, African Bank and other banks in this sector are micro lenders and do not provide credit card facilities, asset management, management of investment funds and investment banking. They provide most of the other services but are focused on the lower market. Citibank, UBS, Rand Merchant Bank, Barclays Bank,etc, provide a combination of the services that micro- lenders do not provide. These services are targeted at the higher end of the market and are mostly asset management, management of investment funds and investment funds.

Market share data (2003)

Corporate, investment and merchant banking: (Market shares in percentage)

	Nedcor	BoE	Stanbic	ABSA	Firstrand	Investec	Others
Cash, cheque and transmission accounts	25.0	1.1	32.8	22.4	18.0	0.2	0.5
Demand deposits	19.4	5.5	16.6	18.9	10.3	5.8	23.5
Loans, advances and overdrafts	17.4	5.7	18.5	16.5	14.8	8.4	18.7
Instalment finance	14.9	4.4	25.8	15.9	28.5	1.9	8.6
Asset management and unit trusts	1.9	1.8	4.2	0.0	10.2	10.2	71.8
Project/ structured finance	12.0	0.0	15.0	12.0	15.0	12.0	34.0
Corporate finance	9.9	0.0	19.5	17.0	15.0	12.0	26.6
Stock broking	0.5	4.0	5.0	0.0	0.0	0.0	90.5

Retail banking – personal banking services: (Market shares in percentage)

	Nedcor	BoE	Stanbic	ABSA	Firstrand	Investec	Others
Cash, cheque and transmission accounts	16.2	1.4	27.0	27.5	27.5	0.0	0.4
Cheque accounts	13.7	1.7	34.7	44.5	22.9	0.0	21.7
Transmission accounts	7.7	1.1	26.9	46.6	22.5	0.0	26.1
Installment credit	14.1	1.1	15.8	36.1	29.6	1.3	2.0
Overdrafts	16.0	1.9	25.5	21.1	28.9	0.0	6.6
Total deposits	21.1	8.2	21.8	23.4	16.1	1.7	7.7
Mortgage	19.7	2.7	19.6	32.5	19.1	1.2	5.2
Credit cards	28.2	1.9	21.2	23.8	21.1	2.3	1.5

Question

(m) is there a single provider for each product? Are there a few large providers? Are there many providers?

Answer

There is no single provider for each product. The top 4 banks, that is, Standard Bank, First National Bank, ABSA and Nedcor provide all these services to all markets. Investec Bank (the 5th largest

bank) only targets the upper market. These 5 banks dominate the South African market notwithstanding some competition from the international banks and micro lenders.

Question

(n) Is there one single consumer of the product considered? Are there a few large entities as major consumers? Are there many consumers?

Answer

There are many consumers for all or a combination of these products. State-owned enterprises, government, large corporations and high net with individuals tend to use the top 5 banks for most of their service requirements.

Question

(o) In geographic terms, how wide is the market for the products concerned?
[are customers' branch/location dependent? What is the willingness of customer to use distant branches?]

Answer

Individual customers are branch/location dependent. The cost of changing bank accounts tends to be high with a high inconvenience factor. As a result, customers tend to stay with one bank for most of their needs. Some however do open a second account. Major corporations, including state-owned enterprises use a number of banks – but still largely within the top 5.

Question

4) Please briefly describe the paperwork required to switch bank for a depositor and whether there are fees (how high?) that banks require to close an account
[what are the fees associated? What are the fees for opening an account, minimum balances, fees for closing an account]

Answer

Many of the banks, particularly the top 5 banks require a minimum amount for opening a bank account. This usually amounts to about R100.00 and in some cases a lower amount is required for opening the bank account. In addition, banks require that this amount be maintained to keep the account open. Generally, customers tend to use the bank account to deposit their salaries and to then extend the services that they need from the bank to a number of others- including mortgages and credit card payments. As a result, most of the customers tend to use the same bank where they deposit their salaries for all other service requirements. This will also then extend to a cheque account. Once a customer obtains most of his or her services (those described) from a particular bank, it becomes very difficult to therefore change banks even if this does not require closing any specific account. This also is the case in instances where a new bank requires a fee to be paid for opening an account. The answer to question 3 (c) is instructive in this regard.

Question

5) Is access of bank financing by the business sector based on:
a) collateral guarantees (*i.e.* real estate)?
b) political patronage?
c) nature/size/length of time of existence of the firm?
d) accurate risk assessment of the project to be financed?

Answer

Most of the banks require that guarantees are provided by any person or institution wanting a loan. In most instances, real estate and life insurance policies tend to be provided as collateral for any bank loan. It is highly unlikely that political patronage is put up as an accepted collateral to a bank loan. We are unaware of an environment where political patronage has been used in the South African market. With respect to the relationship between the bank and the person seeking the finance, most of the banks tend to consider the relationship and the profile of the bank or institution requiring a loan. Where a person or institution has long been a customer of a bank, the requirements and the extent of the discretion that the bank will use in favour of that person or institution tends to be much higher. Therefore it does provide a lot of assistance or usefulness where there is a long-standing relationship between the lender and the lendee. All banks then tend to conduct a full risk assessment of the project to be financed, this is irrespective of the relationship that the bank and the customer will have but the discretion that a bank will apply in granting the loan requested will depend on the factors that I described in this paragraph.

Question

6) **What is the importance of the informal non institutional sector (families, friends etc.) for providing credit to the business sector, especially to smaller firms?**

Answer

To our knowledge, the informal non-institutional sectors play a very limited role in a decision on whether or not a bank will provide credit to a small business or individuals wanting to start small businesses. Most of the factors remain the same as those identified in question 5. This type of relationship will only assist a small business if it is owned by an individual who has had a long relationship with the bank but only to the extent that the bank may not put as strong requirements as they otherwise would to a customer who is only contacting the bank for the first time. So, the non-institutional sector element does provide but very limited assistance in this regard.

Question

7) **Does lender have access to customer credit report from reporting agency (Equifax, etc)? How transparent are business financial statements – e.g. bank more likely to lend to publicly traded company because more financial information is available? Does the regulator collect and provide to all banks an up to date register of all major debtors in the country (with a precise indication of the risk associated with each debtor), so that also a new entrant in banking can provide credit to local entrepreneurs? Is the information costly? Timely? Reliable? How do banks measure risk of borrower?**

Answer

The lender has access to various credit reporting agencies who retain the credit profiles of all individuals who have required to purchase goods and services on credit. Banks are more likely to borrow money to companies who have transparent financial records and statements. The regulator does not provide banks with a risk profile of all debtors. Banks use various credit bureaus to check the risk of their debtors at their own expense. Banks measure the risk of borrowers by looking at their credit records, their financial statements and the manner that their accounts have been managed.

The Micro Finance Regulatory Council established a National Register for Loans but it has information on the lenders that are registered only. Due to the lax nature of the lending industry and the credit industry and its regulations, debtors almost always run the risk of lending to one

customer, which leads to over indebtedness amongst consumers as they cannot resist credit. There is asymmetric information so it is not always easy for a new entrant to know the industry well enough until he or she is a player in the market. Banks rely on the credit records of customers and also have criteria that they measure the customer against before credit is granted.

Question

8) In general do the official accounts of business firms provide a clear picture of their credit worthiness or do companies regularly have a double set of accounts (one for fiscal and one for company management purposes)?

Answer

Most companies have a single account for the management of their businesses i.e. for both fiscal and company management purposes. Therefore, banks are able to get a clear indication or picture of their credit worthiness from their audited financial statements. All firms, if it is in South Africa, private or publicly listed are required to have audited financial statements for any financial year. Therefore, lending banks tend to require these statements to determine the credit worthiness of that particular entity.

Question

9) In the case of a non performing loan what are the options open to a bank (selling the collateral, suing the debtor, asking for government relief, etc.)? In the answer please provide some indication on the timing of each procedure and on the costs involved.

Answer

Debtor are pursued by creditors and sometimes handed over to credit collectors who also charge the debtor collection fees. If no money is retrieved, debtors are blacklisted. Sometimes the debt is written off. The timing of the procedure and the costs are known to collectors, who may charge interest on the outstanding loan or capital daily, as they use their own discretion, though there are regulations to guide them.

Question

10) Do businesses in general have a credit relationship with only one bank or is the phenomenon of multi banks credit widespread?

Answer

Most businesses in South Africa, particularly the larger corporations, tend to have a credit relationship with a number of banks at the same time depending on the nature of the business to which the account is allocated. It is common in most cases for an entity to have a large part of its business associated with one particular bank and the remaining part split between a number of banks. The general approach however, is that the multi banks phenomenon is standard.

Sector-specific regulation in banking: Institutional setting

Question

11) Please describe the institutional structure of banking regulation in your country. What body/agency is responsible for bank regulation? Is there more

than one regulatory agency (such as a "Banking Commission", or a "Financial Services Authority" - in some countries this role is played by the central bank)? To whom is/are it/they responsible or accountable (prime minister/finance minister/legislative body…)? What is the form of this institution, its principal functions and statutory objectives? How transparent is its decision making? Are its decisions published? What discretion does it have? How does it exercise that discretion? Etc.

Answer

In South Africa, banks are regulated by two primary regulators, the Competition Commission in respect of all competition matters and the Registrar of Banks with respect to sector specific issues. The Registrar of Banks is located within the central bank, the South African Reserve Bank. It regulates all Banks in terms of the Banks Act.

The Registrar of Banks falls within the responsibility of the governor of the South African Reserve Bank. The Reserve Bank falls under the political responsibility of the Minister of Finance. The office of the Registrar of Banks regulates the banking industry in what is perceived to be an environment that can benefit from greater transparency. Most of the decisions of the Registrar of Banks are generally made public by the Registrar through official press statements. Some of the information is available on the website of the Reserve Bank.

The primary responsibility of the Registrar of Banks is to ensure and promote the safety and soundness of banks and banking groups registered in South Africa through the effective application of international regulatory and supervisory standards. This entails, among other things, ensuring the existence of sound risk management practices, sound corporate governance structures, fit-and-proper management and financial stability. Furthermore, the Registrar is responsible for the registration and deregistration of banks and handling litigation by and against the Office of Banks.

Sector-specific regulation in banking: Structural regulation

Question

12) Can you describe the rules on branching and new entry in your country?

Answer

The elements affecting the ease of entry into the South African financial services markets and the banking industry specifically are regulatory requirements, capital outlay, expertise and skills of human resources, brand loyalty and switching costs, sunk costs and scale and scope of operations.

The regulatory requirements for entry into the financial services or banking markets remain high. Financial market liberalization has however lowered this barrier. It would seem as if the barriers to entry are lower for corporate, investment and merchant banking. This is mainly because entry into this broad market does not necessarily require the entrant to participate in all the separate markets. It does not require the establishment of a geographically widespread branch and agency network or ATM system as switching costs are not high in relation to the average value of transactions.

Question

13) Is the entry of foreign banks specifically regulated? Are there restrictions to their operations in your country, both in terms of market size and of services offered? Once foreign banks have entered the domestic market, are they subject to rules different than those applying to national banks?

Answer

The entry of foreign banks into South Africa is not regulated in a manner that is different to the regulation of local banks. The requirements for operating a bank in South Africa are described in

paragraph 12 above and these are decided by the Registrar of Banks. Once a license for banking operations has been approved by the Registrar of Banks there are no limitations or further restrictions applicable to that particular bank that are not applicable to other banks already in the market.

Question

14) In the case of financial investments into a bank capital (by other banks or by non banks) are the principles of safety and prudence exactly defined (either by the law or by the regulator) so that an investor can anticipate the likely response? How much discretion does the regulator have? How has it been used?

Answer

Investments into a bank are not particularly regulated any differently from any other. In terms of the banks Act, the Registrar of Banks and in some cases the Minister of Finance are required to approve the acquisition of specific share holding by an investor into a particular bank. For an example, the acquisition of a shareholding in a bank above 45% is required to be approved by the Minister of Finance. The acquisition of shareholding below 45% in bank can be approved only by the Registrar of Banks. In both these instances, approval of the Competition Commission or the Competition Tribunal in terms of the Competition Act is also required for an acquisition of shareholding provided that such acquisition constitutes a merger as defined in the Competition legislation. This relates largely to where the acquisition of such shareholding also results in a change of control over that particular bank.

Question

15) Is the expansion of banks regulated? Are there explicit limits to its geographical concentration? Is there regulatory supervision on the opening of new branches?

Answer

The expansion of banks is not regulated by either the Banks Act or any other legislation. Banks operate nationally and in many instances the top 5 banks also operate internationally, particularly in Africa. There is no regulatory supervision on the opening of new branches for banks.

Sector-specific regulation in banking: Behavioral regulation

Question

16) Are there regulatory restrictions on pricing (interest rate controls and other control on prices and fees)? How are they administered? Are there restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements not to hold other securities; including requirements not to hold the control of non financial companies)?

Answer

The Registrar of Banks does not put restrictions on the pricing of interest rates and banking fees. Banks tend to decide on these issues individually. However, the Usury Act does put a limit on the amount of interest that can be charged to customers by those providing finance to customers directly. This is aimed largely at micro lenders and other institutions or businesses that provide services or goods on credit and in pursuant to which rates are imposed for bad credits e.g. furniture shops and other hire purchases. In South Africa, banks also tend to have other investments in either non-banking or non-financial institutions and this is not particularly regulated.

Question

17) Are there requirements to direct credit to favored sectors and enterprises?

Answer

There are no requirements to direct credit to favoured sectors and enterprises. Banks make these decisions individually based on the merits of each consideration.

Question

18) Besides the formal statutory regime, are there any understandings or expectations about the actions of, say, the central bank (such as "lender of last resort" or "too big to fail") or other government agencies which could affect the behaviour of banks?

Answer

Part of the regulatory environment in banking is the responsibility of the Registrar of Banks to maintain systemic risk at acceptable levels in the economy. This means that the Registrar of Banks can and has in the past intervened where a specific bank has run into trouble. In some cases the Registrar of Banks has intervened to save a bank from failing. Whether or not this approach is the best way forward for the regulation of financial institutions or banking in South Africa, the fact of the matter is that the Registrar of Banks is entitled and has performed this particular function. There is however an ongoing debate about whether or not this approach is in the long term desirable.

Competition Regulation in banking

Question

19) Please describe the application of the national competition law to the banking sector. Are there any exemptions to the application of the national competition law that apply to banks? Are banks subject to the general competition law or to specific competition rules (i.e., are there special provisions relating to bank mergers, inter-bank agreements, and so on)? If the latter is the case, are these sector-specific competition rules more restrictive or less restrictive than the national competition laws? What was the public policy reason behind sector-specific competition rules?

Answer

Part of the regulatory environment in banking is the responsibility of the Registrar of Banks to maintain systemic risk at acceptable levels in the economy. This means that the Registrar of Banks can and has in the past intervened where a specific bank has run into trouble. In some cases the Registrar of Banks has intervened to save a bank from failing. Whether or not this approach is the best way forward for the regulation of financial institutions or banking in South Africa, the fact of the matter is that the Registrar of Banks is entitled and has performed this particular function. There is however an ongoing debate about whether or not this approach is in the long term desirable.

Question

20) Who enforces the competition laws in the banking sector? Is it the sole responsibility of the national competition authority? If not, is the responsibility

shared with another agency, or solely the responsibility of another agency? Does this other agency also deal with prudential regulation? If the responsibility is shared, how is it shared? (i.e., are some components of competition law, such as horizontal agreements, the responsibility of one agency and other components, such as the regulation of mergers, the responsibility of another?) Does one agency have a veto over another, or consensus is required? If another agency has sole responsibility for all or part of the competition laws in the banking sector, does the national competition authority have the right to provide advice? Has it ever done so? How was it valued by the regulatory agency? Please comment on the decisions taken by this other agency, from a competition perspective.

Answer

The application of the Competition Act to the banking sector is the responsibility of the Competition Commission, Competition Tribunal and the Competition Appeal Court. In the consideration of systemic issues it has been argued by the Registrar of Banks that it does take into account competition in the banking industry. It has however, been accepted that the extend of the consideration of competition in the banking industry by the Registrar of Banks does not mean that the Registrar of Banks interprets the competition legislation for that particular purpose. It is a general consideration of competition based on public interest considerations that the Registrar of Banks has to consider. The interpretation of the provision of the Competition Act are exclusively reserved for the competition authorities mentioned earlier in the paragraph.

With respect to the regulation of mergers and banking, the merging parties are required to notify all the relevant regulators including both the Registrar of Banks and the Competition authorities whose approval will be required prior to the transaction being consummated. The only instance where the approval of the Competition authorities is not required would be when the Minister of Finance issues a notice in the public interest that the Competition Act particularly the provisions relating to merger regulation do not apply. If either the Competition authorities or the Registrar of Banks does not agree with the merger the merger would not go ahead, that is, the Registrar of Banks can approve a merger and the competition authorities can turn it down. This means that the merger will not go through. This applies also where the competition authorities approve of the merger and the Registrar of Banks turns it down. In other words the decision of either authority constitute a *vito* which the parties would have to consider and deal with prior to going ahead with the merger.

Question

21) Please comment on particular actions taken by the competition authority:

(a) In the case of mergers, what has been the approach of the competition authority to market definition? Which separate markets were identified, why? Have you treated banks as offering a bundle of services to each customer or as offering a multi-product range, with different markets for each product? What was the geographic scope of each market? Has the Internet or telephone banking appreciably affected questions of market definition? Was the informal sector considered in the antitrust analysis of bank behavior?

(b) In the case of horizontal arrangements, have you found that features of the banking industry facilitate collusive arrangements? Have network effects and/or inter-bank agreements relating to, say, ATMs, electronic processing of transactions, payment systems or joint marketing of credit/debit cards raised competition concerns? Have concerns been raised about bank collusion in the wholesale markets, such as the market for government debt?

Have there been specific instances of abuse of dominance or vertical arrangements which have raised competition concerns? For example have there been instances by

dominant companies requiring customers to purchase a product in order to get product customer wants?

Answer

When the Competition Commission (the Commission) evaluates whether or not a merger is likely to substantially influence competition it assesses the strength of competition in the market(s) affected by the merger and the probability that the firms in the market will behave competitively or co-operatively after the merger. The evaluation usually starts with a product and geographic market definition to determine where the impact of the merger on competition would likely be felt.

The second step in the evaluation will be the calculation of market shares and concentration levels in the relevant markets. If these market shares or concentration ratios are very low (that is post merger combined market shares below 15% and HHI's below 1000), the Commission would, but for exceptional circumstances, view the merger as unlikely to decrease the strength of competition in the market and lead to collusive practices.

When, however, the market shares and concentration ratios show that the merger may have anti-competitive effects, the evaluation would include an analysis of other factors that influence the competitive landscape of a particular market. These factors are the level of import competition and the possible constraint that imports may have on competition; the ease of new entry into the market, the level and trends of concentration in the market and history of collusion; degree of countervailing power; dynamic characteristics of the market; the nature and extent of vertical integration; whether the entity purchased is failing and whether the merger will result in the removal of an effective competitor.

In its normal merger evaluation the Commission would consider the effect of the merger on the public interest and, when necessary, consider efficiency arguments.

<u>The relevant markets</u>

In its evaluation of the proposed merger between Nedcor and Stanbic in 2000, the Commission identified the following delineation of the relevant markets in broad banking services between the three distinct categories of:

Corporate, investment and merchant banking

Retail Banking – Personal banking services; and

Retail Banking – Small business banking.

These categories were then further narrowed to distinct product markets.

The following distinct markets are relevant to an analysis on the grounds of market delineation and market share data availability:

<u>Corporate, investment and merchant banking:</u>

Cash, cheque and transmission accounts

Demand deposits

Loans, advances and overdrafts

Instalment finance

Asset management and unit trusts

Project/ structured finance

Corporate finance

Stock broking

<u>Retail banking – personal banking services:</u>

Cash, cheque and transmission accounts

Cheque accounts

Transmission accounts

Installment credit

Overdrafts

Total deposits
Mortgage
Credit cards

The geographic market is national.

Question

22) Are there any other particular issues or experiences in the enforcement of competition law that you think would be of interest to other competition authorities? If so, please describe them briefly and, where relevant, provide citations to any relevant publications.

Answer

None

Question

23) Have there been any important regulatory changes (relating to any of the components of the regulatory regime discussed in the previous paragraphs) in the past two years? If so, briefly describe the situation before the change and the main effects of the change.

Answer

There have been no important regulatory changes in the past two years.