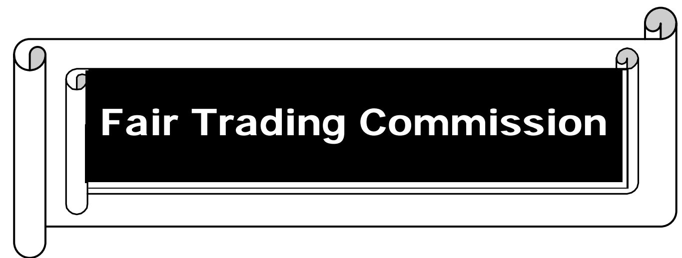


# Competition Policy and the Financial Sector

**October 13, 2004**

## 1. Introduction

1.1 In keeping with the principles of a free-market system, countries should strive to maintain competitive neutrality throughout their economies, i.e. competition policy should apply generally to all commercial entities; regardless of their size; whether they are owned by domestic or foreign interests; or are government or private. This means that all regulatory arrangements which unjustifiably confer a special advantage or disadvantage on any sector of the economy should be repealed or applied sparingly. For sectors in which there is a need to implement other policies to achieve particular objectives, the aim should be to minimize the distortion of the competitive process.

## 2. Financial Services Considerations

2.1 While financial services markets are similar to the market for commodities, they differ in two material respects:

- Crucial information is asymmetrically distributed and costly to obtain; and
- The failure of major financial institutions will cause dislocation for many agents in society.

2.2 For a financial market to be deemed successful it must be both solvent and competitive. If it is sound but not competitive then inefficiencies will abound both in the financial sector itself as well as throughout the economy. One the one hand, the absence of competition is likely to stifle the efficient allocation of credit and/or equity and reduce available savings. This will reduce the economy's growth potential. On the other hand a market which is competitive but not sound is unsustainable; and if the market fails it will cause dislocation throughout the economy.

2.3 Financial institutions are susceptible to "runs" by depositors. If depositors are in doubt about the solvency of a bank and find it difficult or too costly to obtain and process information on the solvency of the bank they will withdraw their deposits from that bank. This may lead to an otherwise solvent bank becoming insolvent.


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This problem is further compounded by the fact that the failure of one bank causes problems for other borrowers and depositors and may lead to runs on other banks, leading to a recession or depression.

2.4 Countries recognizing the interplay between prudential regulation and competition policy have adopted an integrated approach to the application of competition policy in the financial sector.

## 3. Public Interest Considerations under the Fair Competition Act .

### *Sections 17 & 20*

3.1 Section 17 of the FCA "applies to agreements which contain provisions that have as their purpose the substantial lessening of competition, or have or are likely to have the effect of substantially lessening competition in a market." An agreement is not likely to have substantial anti-competitive effects if the parties effecting the agreement do not exercise market power. The FTC therefore takes the view that an agreement will generally not have the effect of substantially lessening competition if the parties' combined share of the relevant market does not exceed 25 percent, although there are circumstances in which this might not be the case.[1]

3.2 Section 20 proscribes abuse of a dominant position. Holding a dominant position is not, in itself a breach of the FCA. It is the abuse of this position that constitutes a breach. An assessment must therefore to be made to determine whether or not an enterprise, if found to be dominant, is exercising its dominant position in a way that adversely affects competition. As a guideline, the FTC will generally consider an enterprise to be dominant if it has a 50 percent market share. This threshold is a guide only. It does not mean that all firms with more than 50 percent market share will necessarily be considered dominant. Conversely, firms with less than 50 percent market share may sometimes be dominant. In conducting the assessment, other factors will be taken into account. For example, the market share of competitors operating in the same market will be considered. In other words, each case will be assessed on its particular merits.

3.3 Not all practices/agreements that fall under Sections 17 & 20 are prohibited by the Act. The Act exempts a practice or an agreement if it meets two positive and one negative conditions:

(a) The positive conditions require that the practice or agreement:

- *Contribute to improving the production or distribution of goods or to promoting technical or economic progress:* - Examples of improvements in production or distribution include lower costs from changes in the methods of production or distribution or economies of scale; product quality improvements; increases in the range of goods or services provided. Examples of the promotion of technical or economic progress include

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[1] See FTC's publication "A Guide to Anticompetitive Practices".


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efficiency improvements from scale economies and specialization, increased research and development and enhanced speed of innovation and technical progress.

- *Allow consumers a fair share of the resulting benefits*: - Consumers, in this context, refer not only to end-users of the goods or services, but also to customers of the parties to the agreement at all levels of the supply chain. If, for example, an improvement is seen as benefiting only the shareholders of the parties to the agreement, this condition would not be satisfied. Consumers must benefit. The benefits may be enjoyed immediately or may lie in the foreseeable future.

(b) The negative condition is that the practice or agreement:

- *Not impose restrictions on firms that are not indispensable to the attainment of the "positive" objectives:* - In addition to demonstrating the benefits to the practice or agreement, any restrictions imposed must also be necessary and not more restrictive than necessary for the attainment of the benefits. In other words, the agreement or practice should be the least restrictive means of achieving the benefits.

3.4 Section 20 also provides a specific exemption in respect of arrangements that are designed only for the purpose of enforcing intellectual property rights under copyright, patent, registered design or trade mark.

### *Section 29*

3.5 Section 29 of the FCA permits the authorization of agreements or practices that are otherwise prohibited under the Act. The Commission will authorize such agreements and practices only if it is satisfied that their detrimental effects are outweighed by the public benefit(s), which they are likely to create. Although "public benefit," is not defined in the Act, it is a well-established principle in other jurisdictions that it means "a total net benefit" which is constituted from a number of other specific benefits. The public benefit test entails weighing the detriment arising out of the agreement or practice against the countervailing benefit(s) to the public, which would result from said agreement or practice.

**Detriments**

3.6 Detriments resulting from a lessening of competition or strengthening of dominance could include lower quality of products, lack of services provided, higher prices than would obtain in the absence of the agreement or practice, and reduction of the range of goods. Measuring these detriments will not be a simple task, because some of them cannot be quantified. Factors that have some bearing on the size of the detriment will include:

- the significance of the particular market within the overall economy in which the lessening of competition occurs;
- the extent to which price signals are likely to be distorted by the earning of excess profits, inefficiencies and/or cross-subsidization;


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- the extent to which lack of competitive pressure may encourage waste; discourage innovation and limit consumer choice; and
- the expected duration of the detriments

3.7 In measuring detriments, focus must also be placed on the structure of the markets and market power and therefore, the potential for detriments to occur, rather than on the current behaviour (i.e., current detriments) of existing market participants. Past and present data must be evaluated in terms of contribution to what is essentially an exercise of judgement about the potential for detriment rather than concentrating on existing detriment(s).

**Public Benefit -Efficiency Improvements**

3.8 A public benefit is any gain that is of benefit to the public, with particular emphasis on efficiency gains. The term "public" encompasses more than simply consumers and could extend to various trade interests. The balancing of public benefit against the detriments of lessening competition or strengthening of dominance involves a comparison of efficiency gains of the former against the efficiency losses from the latter. This does not mean that assessing public benefits must be confined to an analysis of the factors which can be quantified in monetary units ("tangible" factors). Other factors, such as environmental and social factors (i.e., "intangible" factors), can conceptually be included within an efficiency perspective.

3.9 It is essential, however, that the benefits counted be true benefits (i.e., net gains to society) and not just changes in the distribution of wealth *per* se, or transfers between areas of the economy having a net impact of zero. As with the detriments, the expected duration of the benefits is of concern. Globally recognised public benefits include: economic development of natural resources; industry rationalization resulting in more efficient resource allocation and lower unit production cost; increased employment; improvement in the quality and safety of goods and services; and the supply of better information to consumers.

## 4. The Danger of a Blanket Exemption from the FCA or Ceding of the FTC's Jurisdiction

4.1 There are economic reasons however why prudential regulation should not "trump" competition policy. These reasons relate to the interdependent nature of the activities conducted in different markets and the promotion of allocative efficiency. The conditions which prevail in one market can affect the prices and output in another market, either because one good or service is used as an input in the production of other goods, or because the goods and services in question are substitutes or complements. The FTC has investigated several cases in which a firm has used its dominance in one market to restrict the provision of goods or services in another market. Even in cases in which linkages are not obvious, there tends to be a seamless interconnection of the various industries/markets in an economy, due to the role prices and profits play, in redeploying resources across different industries.


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4.2 As was mentioned before, the financial services sector is unique in that market failure in that sector has more far-reaching effects than market failure in any other sector. Therefore, an exemption from the application of competition law in the financial sector or the removal of the FTC's ability to do cross-sector investigations which involve that sector is likely to perpetuate or induce distortions that can affect the efficiency of market activity carried on in other sectors.

## 5. Conclusion

5.1 While cognizant of the fact that the differing objectives of different government policies can create tensions relating to the priority given to competition policy vis-à-vis other policies, the FTC wants to caution against any action which results in the removal of the financial sector from its jurisdiction and/or the exemption of the sector from the provisions of the FCA. Such actions could result in existing distortions, where these might exist in the financial sector, rippling through to other sectors. It is the FTC's position that the provisions of the FCA can be effectively applied to the financial sector without compromising the stability and solvency of the financial system.


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