17 November 2014

Professor Ian Harper
Chair – Competition Policy Review
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Professor Harper

Centre for International Finance and Regulation (CIFR) – Submission to Competition Policy Review

CIFR is pleased to provide this submission to the Inquiry.

CIFR's mission is:

T promote financial sector vibrancy, resiliency an integrity, supporting Australia as a regional financial centre through leading research and education on systemic risk, financial market developments and market and regulatory performance.

CIFR is in a position to draw on its capabilities and network to provide independent and objective research and public policy contributions. In this short submission Dr Rob Nicholls addresses certain aspects of the Interim Report with observations and views supported by output from CIFR-funded research.

We wish you, the Panel and the Secretariat well with the task ahead. Please contact me if we can provide any further assistance, or if there is any other aspect of the Inquiry's work with which we may be able to help. We look forward to contributing further at CIFR's Symposium and Workshops: "Competition Law and Policy in Australia – The Next Two Decades" on 25 November.

Yours sincerely,

Professor David R Gallagher
Chief Executive Officer
CIFR

Key messages

1. This short submission provides material that may be useful to the Competition Policy Inquiry in examining potential unintended consequences of changes to competition law, particularly in the financial services sector. It provides the information set out in Table 1.

Table 1: Key messages

Issue	Messages
Unilateral conduct	The proposed defences to the amended section 46 of the Competition and Consumer Act 2010 may not be available to financial institutions and this may limit innovation. There are a number of alternative measures that can be used to assess competitiveness in the retail banking sector.
Coordinated conduct	Jurisdictional matters limit the potential for cartel conduct action in Australia in respect of benchmark manipulation, in contrast to the outcomes in the European Union. Draft Recommendation 20 could address this issue.
Mergers and acquisitions	The "four pillars" policy has the potential for both a lessening of intensity of competition and the creation of a regulatory blind spot in respect of digital disruption.

Introduction

2. The Centre for International Finance and Regulation (CIFR) appreciates the opportunity to make this short submission to the Final Report process of the Competition Policy Inquiry (the Inquiry).

3. This short submission is intended to cover a few matters raised in the Draft Report entitled "Competition Policy Review" (Draft Report). It represents the views of Dr Rob Nicholls, a Research Fellow at CIFR and not necessarily the views of CIFR or its consortium members.

4. The objective of this submission is to provide some thoughts as to where a competition analysis in the financial services sector, particularly retail banking, may yield results that are different to a similar analysis in other sectors. The intention is not to run the argument that "financial services are different". Instead, the aim is to assist the Inquiry to ensure that its recommendations in the final report do not have the type of unintended consequences that can be problematic.

Unilateral Conduct

5. As the Inquiry makes recommendations that will lead to policy changes, it is my view that it is essential that the critical assumptions of the Inquiry need to be based on best available evidence. The issue of banking sector competitiveness is one of those critical assumptions. Each of the Financial Conduct Authority (FCA)[1] and the Competition and Markets Authority (CMA)[2] has considered competition in the UK financial services sector.

6. The Bank of England has recently published a discussion document that examines fair and effective markets in one of the critical wholesale sectors of the financial services sector.[3] This illustrates the importance of competition law and policy as the driver of intervention in all types of markets without excluding markets for financial services.

7. The CMA has expressed a number of concerns that appear to apply in Australia.[4] Retail banking competitiveness in the UK is greater than it is in the US, but lower than in Australia based on the evidence presented in this submission.

Risk as a driver

8. In assessing competition in order to determine whether conduct has lessened that competition, it is important to recognise that risk analysis is a critical driver of conduct in the financial services sector. This has the potential to mean that drafting of amended elements of the Competition and Consumer Act 2010 could lead to unintended consequences in the financial services sector.

9. The potential issue arises in the proposed approach to defences to section 46. Consider an example. A major bank determines that the default risk for credit card holders in regional Victoria is lower than the national average, and then offers a credit card that is only available to people living in certain post codes in Victoria. The bank decides to create an innovative product that reduces consumer costs based on the lower risk profile. The bank might use direct marketing and advertising on regional television stations to offer this new card that has attractive features compared to the bank's standard card:

1 http://www.fca.org.uk accessed 14 November 2014.
2 https://www.gov.uk/government/organisations/competition-and-markets-authority accessed 14 November 2014.
3 Bank of England, *How fair and effective are the fixed income, foreign exchange and commodities markets?*, Bank of England http://www.bankofengland.co.uk/markets/Documents/femr/consultation271014.pdf (2014).
4 https://www.gov.uk/government/news/personal-current-accounts-and-small-business-banking-not-working-well-for-customers accessed 14 November 2014.

(a) a longer low interest balance transfer period;

(b) a lower interest balance transfer fee; and

(c) a lower ongoing interest rate.

10. However, after a year the bank realises that the default risk for credit card holders in regional Victoria has changed back to the national average (perhaps as a result of the bank's own activity). As a result, it withdraws the offer for new customers and, over time and consistent with the terms of service of the card, eliminates the regional card product altogether.

11. We assume that a regional bank in the area, which did not take the same view of default risk for credit card holders in regional Victoria and did not introduce a competitive offering, has lost significant market share as a result of the innovative entry.

12. If the bank could be shown to have a substantial degree of power in a market, then it is unlikely that either of the defences proposed in Draft Recommendation 25 of the Draft Report would be available. The potential unintended consequence is that innovation will be deterred, and that this will have a negative effect on competitive intensity.

Competition in banking

13. Competition in banking acts to increase social welfare in the same way that competition works in any other sector. The academic literature on the balance between competition and stability in the financial services sector follows two competing views:[5]

(a) the "competition-fragility" view, in which competition lowers bank margins and encourages adverse risk taking; and

(b) the "competition-stability" view, in which market power in the provision of loans exacerbates moral hazard and adverse selection problems.

5 See, for example, Thorsten Beck, 'Bank Competition and Financial Stability: Friends or Foes?' (World Bank, 2008); Thorsten Beck, Asli Demirgüç-Kunt and Vojislav Maksimovic, 'Bank Competition and Access to Finance: International Evidence' (2004) 36(3) *Journal of Money, Credit and Banking* 627; Allen N. Berger et al, 'Bank Concentration and Competition: An Evolution in the Making'ibid. 433; Allen N. Berger, Leora F. Klapper and Rima Turk-Ariss, 'Bank Competition and Financial Stability' (2009) 35(2) *Journal of Financial Services Research* 99; Nicola Cetorelli, 'Real Effects of Bank Competition' (2004) 36(3) *Journal of Money, Credit and Banking* 543.

14. These simple contrasts are made more complicated with the more nuanced pair of competing views:[6]

    (a) the "more credit" view, in which bank competition leads to more credit availability, more firm entry and more growth; and

    (b) the "less credit" view, where credit availability may be higher in less competitive environments.

15. Historical competitive analysis in the financial services sector has used market concentration or margin levels as an indication of competitive intensity. However, there are a number of alternative indicators of banking competitiveness.

16. The Panzar-Rosse H-statistic captures the elasticity of bank interest revenues to input prices. It is calculated in two steps:

    (a) running a regression of the log of gross total revenues (or the log of interest revenues) on log measures of banks' input prices; and

    (b) adding the estimated coefficients for each input price including deposits, staff, equipment and fixed capital.[7]

17. Higher values of the H-statistic are associated with more competitive banking systems. In a monopoly, the demand curve is downward sloping and an increase in input prices results in a rise in marginal costs, a fall in output, and a decline in revenues. This leads to an H-statistic less than or equal to 0. Under perfect competition, an increase in input prices raises both marginal costs and total revenues by the same amount and the H-statistic will equal 1.

18. The Lerner Index is defined as the difference between output prices and marginal costs (relative to prices). Prices are calculated as total bank revenue over assets and marginal costs are obtained from an estimated translog cost function with respect to output. Higher values of the Lerner index signal less bank competition.[8]

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6 See, for example, Nicola Cetorelli and Pietro F. Peretto, 'Credit quantity and credit quality: Bank competition and capital accumulation' (2012) 147(3) *Journal of Economic Theory* 967.

7 See, for example, Jacob A. Bikker and Katharina Haaf, 'Competition, concentration and their relationship: An empirical analysis of the banking industry' (2002) 26(11) *Journal of Banking & Finance* 2191.

8 See, for example, Joaquín Maudos and Juan Fernández de Guevara, 'Factors explaining the interest margin in the banking sectors of the European Union' (2004) 28(9) ibid.2259.This paper concludes that the European reduction in interest margins was driven by cost reduction in the sector.

19. A third and more recent approach is the Boone Indicator.[9] It measures the effect of efficiency on performance in terms of profits on the basis that more efficient banks achieve higher profits. It is calculated as the elasticity of profits to marginal costs. This elasticity is calculated by regressing the log of a measure of profits (such as return on assets) against a log measure of marginal costs. The elasticity is captured by the coefficient on log marginal costs. The more negative the Boone indicator, the higher the level of competition is in the market.

Concentration

20. The literature on banking competition suggests that concentration alone does not provide a good indicator of competitiveness in the banking sector. Indeed, there can be vibrant competition in highly concentrated sectors based on innovative products and pricing.

21. This becomes critical in the context of the application of a substantial lessening of competition test. The blunt tools offered by either the Herfindahl–Hirschman Index, or by simple margin analysis, cannot provide the level of information required to determine the degree and intensity of rivalry that is occurring in the financial services sector.

22. On the other hand, if market concentration is high, there is a risk of oligopoly behaviour. In the banking sector, this would be expressed as a Cournot model. One issue with reliance on margins as an indicator of banking competitiveness is that the same outcome would flow from a Cournot model. Also, they would be exacerbated by the types of price signalling that are currently prohibited in ss. 44ZZW and 44ZZX of the *Competition and Consumer Act 2010,* and which are also proposed to be prohibited by amendments to section 45 of that Act. The redundancy of the price-signalling provisions is well described in the Draft Report.

23. The advantage of using indicators of competitiveness such as the Lerner Index and the Boone Indicator is that they can be applied in a concentrated sector in order to determine the level of competitiveness.

Indicators of competition in Australian banking

24. CIFR has funded research, which is currently in progress, of the four pillar banks at a group level in respect of competitiveness and efficiency. This work

9 See, for example, Jan Boone, 'A New Way to Measure Competition' (2008) 118(531) *The Economic Journal* 1245; Jan Boone, 'Competition: Theoretical Parameterizations and Empirical Measures' (2008) 164(4) *Journal of Institutional and Theoretical Economics (JITE) / Zeitschrift für die gesamte Staatswissenschaft* 587.

has used data envelopment analysis, Lerner Index, H-Statistic and Boone Indicator. However, we are mindful that the Inquiry may wish to be able to reproduce the results that we obtained using data from both APRA and the public reports on the banks. As a consequence, this submission presents data from reputable but independent sources. Specifically, the submission uses the data set provided by the World Bank and used extensively by the Federal Reserve system in the US as well as in Europe.

25. The H-Statistic for the banking sector for a number of countries and globally is available in the World Bank Global Financial Development Database.[10] The data subset known as GFDD.OI.03 contains the H-Statistic. There is limited Australian data but there are results for 2010. These are set out in Table 2.

Table 2: H-Statistic for banking in selected geographic areas

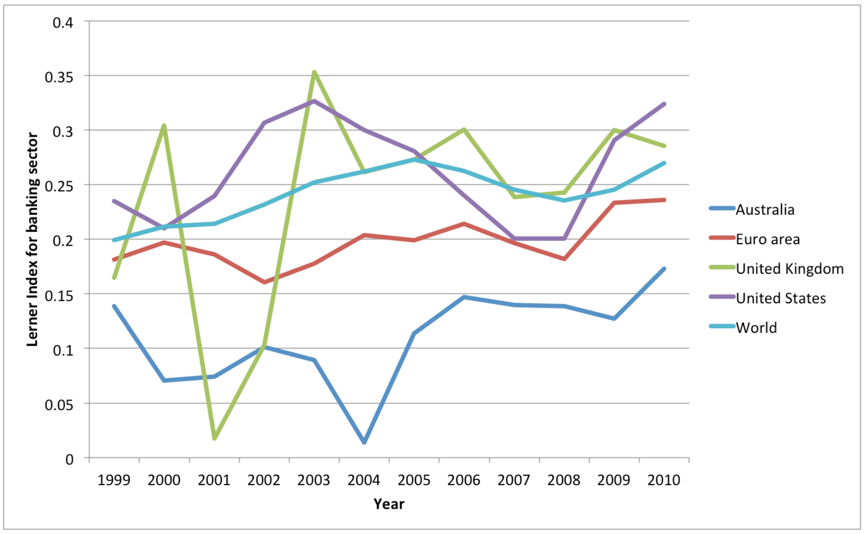
Region	H-Statistic
Australia	0.651
Euro Area	0.651
United Kingdom	0.642
United States	0.689
World	0.65

26. Based on the H-Statistic for 2010, it could reasonably be concluded that: the US has a more competitive banking sector than the UK; and that Australian banking competitiveness lies between the UK and the US at a level that is comparable with the Euro Area and the world as a whole.

27. The Lerner Index for the banking sector for a number of countries and globally is available in the World Bank Global Financial Development Database.[11] The data subset known as GFDD.OI.04 contains the Lerner Index. Australian data is available from 1999 to 2010. This is set out in Figure 1.

10 http://data.worldbank.org/data-catalog/global-financial-development accessed 14 November 2014.
11 http://data.worldbank.org/data-catalog/global-financial-development accessed 14 November 2014.

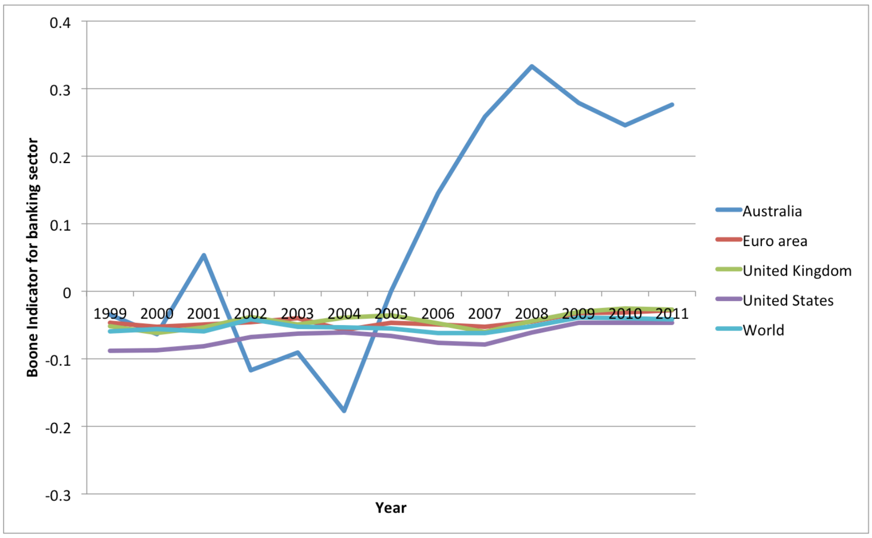
Figure 1: Lerner Index for banking over time for selected geographic areas



28. Figure 1 indicates that Australia's banking sector is more competitive than the other geographic areas, that the UK reached the highest level of competitiveness in 2001, and that Australian banking competitiveness peaked in 2004.

29. The Boone Indicator for the banking sector for a number of countries and globally is available in the World Bank Global Financial Development Database.[12] The data subset known as GFDD.OI.05 contains the Boone Indicator. Australian data is available from 1999 to 2011. This is set out in Figure 2.

Figure 2: Boone Indicator for banking over time for selected geographic areas



12 http://data.worldbank.org/data-catalog/global-financial-development accessed 14 November 2014.

30. Figure 2 indicates that Australia's banking sector is less competitive than the other geographic areas. The volatility and extreme nature of the Australian results makes the World Bank data questionable. The data indicates such a lack of competitiveness, compared to the other measures set out above, that it may be unreliable. However, correspondence with the World Bank has not led to a revision in its published data.

Coordinated conduct – difficulties in cartel action

31. It may be difficult for the ACCC to take an action against a financial institution which has engaged in cartel conduct in relation to manipulation of financial benchmarks such as:

 (a) inter-bank offered rate;

 (b) foreign exchange rates; or

 (c) bid/ask spreads.

32. The issue is that the manipulation is likely to have occurred in a different jurisdiction. This problem is magnified by the Federal Court decision[13] on the international airfreight cartel.[14] Although the Competition and Consumer Act 2010 (Cth) has been amended to clarify jurisdictional issues since the airfreight cartel conduct and the case is likely to be appealed, it is difficult to demonstrate the nexus between the manipulation and the jurisdiction[15]. In any case, whereas there is some indication that the locally set benchmarks (such as the bank bill swap rate – BBSW), have been manipulated[16], there has been no public ACCC cartel conduct action. This is in contrast to the New Zealand Commerce Commission's announcement that it had provided an immunity marker to at least one financial institution.[17]

33. The European Union has followed the path of using cartel conduct to deal with financial benchmark manipulation.[18] The twin announcements of further cartel settlements in October 2014 and the retiring Commissioner Almunia's

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13 Australian Competition and Consumer Commission v Air New Zealand Limited [2014] FCA 1157 available at http://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/single/2014/2014fca1157 accessed 14 November 2014

14 See, for example, Mark S. LeClair, 'Exigency and Innovation in Collusion' (2012) 8(2) *Journal of Competition Law and Economics* 399.

15 See, for example, Gunnar Niels, 'Back to First Principles of Market Definition: The New Zealand High Court Air Cargo Cartel Case' (2013) 36(3) *World Competition* 373.

16 http://www.afr.com/p/business/companies/ubs_traders_tried_to_game_australian_0Bbkz7A5PfZvHJQpe3UytK accessed 14 November 2014.

17 http://www.comcom.govt.nz/the-commission/media-centre/media-releases/detail/2014/commerce-commission-confirms-forex-investigation accessed 14 November 2014

18 See, for example, Rob Nicholls and Justin O'Brien, 'Hanging together or hanging separately: is competition law in the process of eclipsing financial regulation?' (2014) 8(2) *Law and Financial Markets Review* 178.

speech[19] on the passing of the antitrust litigation directive[20] suggest that the Final Report should not foreclose this approach. International experience suggests that the definition of market proposal in Draft Recommendation 20 in the Draft Report is critical in the financial services context.

Mergers and acquisitions

34. One of the fundamental approaches in the Draft Report is the need for Governments at all levels in Australia to avoid unnecessary intervention:[21]

Legislative frameworks and government policies binding the public or private sectors should not restrict competition.

35. There is good reason to consider that the "four pillars" policy[22] in the banking sector is a policy that should be removed in accordance with Draft Recommendation 1.

36. The removal of the four pillars policy is not likely to result in mergers between the "Big Four". It is not unreasonable to assume that the operation of section 50 of the *Competition and Consumer Act 2010* means that the analysis of any such potential merger would lead to the ACCC finding that the merger would lead to a substantial lessening of competition in a market.

37. Competition and contestability arise when there are reasonably low barriers to entry and exit from the sector. It is not clear that low barriers to entry exist in Australia and evidence to support this view comes from the failure of international banks to gain a significant toehold in the retail banking sector in Australia.

38. The four pillars policy creates a barrier to exit for each of ANZ, CBA, NAB and Westpac except by way of a trade sale to an international bank and subject to approval by APRA and the Foreign Investment Review Board. Low margins in banking, used as evidence of competitiveness in the Interim Report of the Murray Inquiry[23], are potentially a barrier to entry. The effect may be that competitive entry is only by industry disruptors.[24]

39. The four pillars policy has led to a degree of vertical integration in the sector, particularly in the sale of mortgage products. There was a contraction in the

19 http://europa.eu/rapid/press-release_SPEECH-14-713_en.htm accessed 14 November 2014.
20 http://europa.eu/rapid/press-release_IP-14-1580_en.htm accessed 14 November 2014.
21 Draft Report p24 – Draft Recommendation 1 – Competition principles
22 http://fsi.treasury.gov.au/content/PublicInformation/Pressreleases/PR090497.asp accessed 14 November 2014.
23 http://fsi.gov.au/publications/interim-report/ accessed 14 November 2014.
24 See, for example, Ron Adner, 'When are technologies disruptive? A demand-based view of the emergence of competition' (2002) 23(8) *Strategic Management Journal* 667.

proportion of loans provided by banks other than the Big Four and by the non-bank mortgage sector associated with the global financial crisis.[25] Since then, there has been a contraction in the diversity of mortgage intermediaries with CBA acquiring 80% of Aussie Home Loans[26] and Westpac acquiring RAMS' brand and distribution business[27].

40. Within the constraints of the four pillars policy, there have been recent acquisitions by the Big Four banks with Westpac acquiring St George[28] and CBA acquiring BankWest[29]. There has also been a significant amount of horizontal integration in the sector in the areas of wealth management, insurance and specialised finance.

41. There are major issues that flow from the horizontal and vertical integration in the banking sector. The primary one is that systemic risk becomes more domesticated and crosses multiple elements of the Australian financial system. For example, NAB provides banking, wealth management, insurance (through MLC) and a range of wholesale superannuation products and services. The bank has the potential to be "too big to fail" not from its banking operations, but due to its impact in the superannuation sector.[30]

42. The problem with the four pillars policy arises from the regulatory culture that it creates. APRA's finding[31] that only the Big Four are Domestically-Systemically Important Banks (D-SIB or local "too big to fail" banks) compounds the issue.

43. The institutionalisation of the Big Four has the potential for both a lessening of intensity of competition and the creation of a regulatory blind spot in respect of digital disruption.

44. The lessening of intensity of competition effect comes from the barriers to entry raised around the Big Four. Although the regulatory regime might permit new entry, the regulatory focus is on the Big Four on the basis that they are critical to stability. The entry or exit of a potential competitor is not the highest regulatory priority.

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25 See ABS Housing Finance 5609.0 and specifically Table 13b. HOUSING FINANCE COMMITMENTS (Owner Occupation), By Purpose and Lender: Australia, Original ($000)

26 http://www.aussie.com.au/about-us/ accessed 14 November 2014.

27 http://www.rams.com.au/about-rams/ accessed 14 November 2014.

28 https://www.westpac.com.au/about-westpac/investor-centre/shareholder-information/shares-hybrids/stgeorge-merger/ accessed 14 November 2014.

29 https://www.commbank.com.au/about-us/news/media-releases/2008/081008-news-bankwest-acquisition.html accessed 14 November 2014.

30 See, for example, M. Scott Donald and Rob Nicholls, 'Bank Custodians and Systemic Risk in the Australian Superannuation System' (2015) Forthcoming 2015 *Journal of Banking and Finance Law and Practice*.

31 http://www.apra.gov.au/mediareleases/pages/13_40.aspx accessed 14 November 2014.

45. The blind spot comes from the same regulatory focus. The potential transformative effects of peer-to-peer lending[32] and from PayPal providing working capital loans to small and medium enterprises[33] are examples of the types of digital disruption that the regulatory regime is designed to ignore. These types of structural change that arise from the innovation that is expected from a competitive environment are recognised by the smaller players[34], but are regarded as unimportant by the too big to fail entities[35].

Conclusions

46. CIFR is funding additional research in these areas in a project entitled "Competition law and policy in Australian financial services regulation". This research project will examine and review the competition environment in the financial services sector. It aims to identify forms of competition in the financial services sector, the role of financial regulators in the promotion of competition, the extent to which there is scope for sector specific competition regulation and the balance between stability and competition.

47. The research question for this project is:

- What are the optimal competition law and policy settings that should apply to the financial services sector?

32 http://www.smh.com.au/business/ratesetter-targets-australian-8216savers8217-with-new-lending-website-20141111-11kf2m.html accessed 14 November 2014.
33 https://www.paypal.com/webapps/workingcapital/ accessed 14 November 2014.
34 http://www.smh.com.au/business/banking-and-finance/bendigo-bank-chief-warns-of-paypal-apple-threat-20141027-11cj14.html accessed 14 November 2014.
35 http://www.itnews.com.au/CXOChallenge/397835,debunking-the-innovation-myth.aspx?utm_source=feed&utm_medium=rss&utm_campaign=iTnews+&utm_reader=feedly accessed 14 November 2014.