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Competition Policy in the Financial Sector in Latin America

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The views expressed here are those of the author and do not necessarily represent the views of the Organization for Economic Co-operation and Development (OECD) or the Inter-American Development Bank (IDB). This paper benefited particularly from views and insights in the work of Darryl Biggar, Sean Ennis and Alberto Heimler.

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Preface

The present study has been financed by the European Representation of the Inter-american Development Bank (IDB), within the framework of the co-operation agreement the IDB has with the Organisation for Economic Co-operation (OECD) in the field of competition.

It was officially presented during the IV Latin American Competition Forum (LACF) held on 11 & 12 july 2006 in San Salvador (el Salvador). This Forum is co-sponsored by both institutions, with the support of the local competition authorities.

The Forum's objective is to enhance the role of competition in Latin American and Caribbean economies by promoting dialogue, consensus building and networking among policy makers in the region, as a means to improve the business climate.

Senior officials of competition authorities and sector regulators, as well as international and multilateral institutions experts meet once a year al the LACF.

The author of this study, Marta Troya, makes an in depth analysis of the financial sector peculiarities in relation to the competition laws and policies, and the role of competition authorities and regulatory entities in a sector which, although mainly privately owned, has a strong public service role. In the study, the author concentrates in two cases such as banking mergers and payment card issues.

Main conclusion: competition authorities should be in charge of watching over and promoting competition in the financial markets, while letting financial regulators the task of ensuring financial soundness and stability of the sector. This task division shall not exclude in any way a close co-operation between both authorities when proven necessary.

Abstract

This paper discusses the scope and role of competition law in the financial sector in Latin America. In common with many sectors, the financial sector often argues that it should not be subject to general competition law, as it has particular needs; notably prudential regulation, that may be inconsistent with strong competition. This paper explains the benefits that arise from application of general competition law to a sector by a non-sectoral regulator, such as a competition authority. The paper pays particular attention to evaluation of bank mergers and payment card issues.

I. Introduction

1. The business of the financial sector is to act as an intermediary between savers and investors and provide financial services, particularly payment services. This sector comprises a variety of financial institutions such as commercial banks, finance companies, securities companies and insurance companies. Financial services are important to the economy, as they are essential inputs in overall economic production.

2. All financial institutions are affected by a great variety of risks, such as liquidity risk or default risk, and a multiplicity of market failures, such as externalities or asymmetric information, that take place in the financial sector. Because of these risks, the market failures and the special role that financial institutions play in the stability of the financial system, financial institutions are singled out for special regulatory attention. This unique position has not only motivated the introduction of sectoral regulation but also, at times, the exemption of the sector from general competition law.

3. However, financial services are being reshaped by the globalisation of financial markets, technological advances, and structural changes, including the lowering of regulatory barriers.

4. Countries should consider the best way to supervise the sector under this new scenario. Should the financial sector in general and the banking sector in particular be excluded from competition law? What should be the role of the competition authority and the regulator in promoting competition? Should bank mergers be treated differently from other mergers? Should competition policy apply to the payment cards market? These questions are of particular relevance for developing countries as evidence shows that a well-developed financial sector is important for achieving both long-term economic growth and the reduction of poverty.[1]

5. This paper reviews from an economic perspective, and relying on country experiences, the role that the competition authority should take in the financial sector as a whole. Moreover, it analyses in depth, two areas of the financial sector where the competition authority may intervene: bank mergers and the payment card market. In particular, it identifies the primary markets of concern in bank mergers, such as consumer banking and small business loans and discusses an approach for assessing competition in these areas, with examples from Latin America. The paper also considers the relative roles of banking regulators and competition authorities in banking mergers and argues that competition authorities have the competencies necessary for banking competition reviews, but not for prudential reviews. Regarding payment cards, the paper identifies the key competition issues for payment cards in Latin America and the role-played by competition authorities, courts and financial regulators for resolving these competition issues. Competition authority action has been, in some cases, a result of regulatory inaction, or in other words, competition authority powers can be an essential supplement to regulation in the case of regulatory inactivity.

6. The remainder of the paper is structured as follows. Section II will review the main anticompetitive issues in the financial sector as a whole and will discuss the role of the competition authority in the sector. Section III will review the issues that arise in a bank merger. Section IV will do the same exercise for the payment card market. Finally, section V will conclude.

II. The financial sector

7. The business of the financial sector is to act as an intermediary between savers and investors and provide financial services, particularly payment services.

8. Without financial intermediaries, a net saver, say a household, would find it particularly unattractive to invest in a net borrower, say a corporation, because of the existence of monitoring costs (i.e. the household will need to control that the use of its investment is the agreed one), liquidity costs (i.e. the investment may not be transformable into cash when the household need it the most) and price risk (i.e. the household risks obtaining a lower sale price of its investment than the purchase price). Financial intermediaries surmount this situation by using two mechanisms. First, financial intermediaries are able to offer superior liquidity and price risk conditions by diversifying some of their portfolio risk; and second, financial intermediaries can monitor borrowers more efficiently because they have economies of scale in information collection and in transaction costs.

9. Originally, the banking sector often provided all the financial services under one roof (commercial banking, investment banking, stock investing services, insurance providers, etc.); however, this sector now comprises a variety of separate financial institutions such as commercial banks, saving banks, IBF (International Banking Facility) operators, finance companies, securities companies, life insurance companies, insurance companies, investment service companies, thrift institutions, pension funds, mortgage companies and stock markets. Apart from these financial institutions, in many countries non-financial institutions are also entering the market.

A. Can the financial sector be a competitive market?

10. It is widely accepted that markets tend to operate most efficiently and deliver more benefits to consumers (for instance in terms of encouragement of low costs and more innovation) under a competitive framework.[2] However, there are limits to how such a framework can be applied to the financial sector.

11. To begin with, all financial institutions are affected by a great variety of **risks**, for instance, all hold some assets that are potentially subject to default or credit risk, all are exposed to some degree of saver withdrawal or liquidity risk, depending on the type of claims they have sold to liability holders and most are exposed to some type of underwriting risk, whether through the sale of securities or the issue of various types of credit guarantees on or off the balance sheet. In the banking sector, for instance, there is the risk of bank runs because 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." Biggar and Heimler [2005], p. 6

12. Apart from these risks, the market is affected by a variety of **market failures**, which are situations in which the actual markets depart from the competitive ideal.

13. In the first place, there are many situations in which **asymmetry of information** exists among market participants, for instance between savers and borrowers. If this asymmetry of information arises at the time of contracting, for example when the lender does not know the default probabilities of the borrowers or when the insurer lacks information on a consumer's risk, the asymmetry of information may lead to what is known in economics as ***adverse selection*** (i.e. only the worst borrowers or insurance takers will be attracted to the lender or insurer). When the asymmetry of information is post-contractual, it may lead to ***moral hazard***. Moral hazard occurs because if the lender is not well informed about the actions taken by the borrowers, the borrowers have an incentive to engage in a riskier activity than the one agreed, once the financing is in place.

14. The second market failure refers to the existence of **externalities**, which arise when a decision causes costs or benefits to stakeholders other than the person making the decision, and therefore, the decision-maker does not bear all of the costs or reap all of the gains from his or her action. In the financial sector, this situation may arise very often because financial institutions do not take into account their central role in the economy when taking decisions. For example, bank failures may wipe out household savings and at the same time restrict a firm's access to credit. Similarly, insurance company failures may leave households exposed to sudden drops in income on retirement and catastrophic illnesses or events. However, one of the most damaging externalities that could take place in the banking sector, when the failure of one bank leads to the failure of other banks, through at least two mechanisms: "consequent failure"[3] and "contagion failure",[4] is not fully taken into account by banks. As a result, banks may accept more risk than what would be optimal from the social point of view.

15. Finally, the third market failure relates to the fact that some agents may have **market power** and therefore do not act as a price takers. Financial institutions may enjoy market power for many reasons including the existence of ***switching costs***, which are the costs incurred when a customer changes from one supplier or marketplace to another. The banking and insurance sectors are particularly affected by this problem. For instance, in the banking sector, two types of switching costs arise. The most known switching cost arises in the bank deposit market, when consumers changing bank account supplier face transaction costs[5] in switching supplier. However, there are switching costs in bank lending too, provided that credit risk of customers is not publicly available, which is likely to be the case in developing countries. These costs usually arise once a borrower has established a relationship with a bank because this bank learns over time whether that borrower is a good or bad credit risk and offer an interest rate accordingly. If other banks do not have access to the customer's existing bank's information, then a customer with a good credit record is likely to face higher interest rates when switching banks. The same phenomenon arises in the insurance sector with the price of insurance: "Over time, however, an insurer may gain an advantage over its rivals by having access to information on its customers that is not available to other insurers. This may make it possible for insurers to keep their old customers and still earn a profit, i.e., consumers may get informationally locked in." Nilssen [2000], pp. 642

16. The presence of switching costs will prevent potential competitors from entering as they will find it hard to get customers. Since financial services rely to large extent on networks, entry may be further restricted due to the presence of ***network externalities***. When there are positive network externalities, the network users' utility increases when more users use the same or compatible product, thus joining and boosting the network. The customer's decision of which network to join is strongly affected by the existing network size. For instance, for

the case of payment services, which are provided through a payment system (i.e. a network) there are "large network externalities, because the scope for electronic payment services largely depends on the degree to which users adopt a common standard. The financial service provider that manages to achieve this common standard may end up with a large share of the market, decreasing competition. These concerns also apply to trading systems and exchanges, to financial portals, and to lesser extent to e-enables" Claessens *et al* [2003], pp. 113 and 114.

17. Furthermore, the sector is also affected by the existence of ***sunk costs***[6], such as the reputation of an existing brand, and ***high fixed costs***[7], such as information technology investments, which further contribute to increase the barriers to entry.[8]

18. Because of these risks, the existence of market failures and the special role that financial institutions play in the stability of the financial system, financial institutions are singled out for special regulatory attention and for general competition law exemption. Therefore, in the financial sector, and unlike other sectors, the issue of competition can not be looked at in isolation as there are tradeoffs between competition on one hand and safety, soundness and innovation considerations on the other hand.

B. Regulation of the financial sector

19. In response to the problems stated above, the financial sector has traditionally been regulated. Some of the most usual regulatory measures are discussed below along with examples.

20. The first group of measures are targeted to control and to limit **entry** into the financial sector. To start with, ***capital adequacy requirements*** usually take the form of a minimum level of required capital and are targeted to ensure that financial institutions follow a responsible credit policy, in the absence of an effective control on the part of depositors. The requirements are, therefore, directed to address the problem of asymmetric information and risk as capital acts as a buffer against any losses incurred by the bank, thus safeguarding depositors' funds. Many countries complement this measure with the requirement of maintaining a particular capital ratio. In Argentina, for example, the Central Bank has divided jurisdictions into four zones, based on location, where the minimum capital requirement is a decreasing amount from 25 to 10 million pesos for banks and from 10 to 5 million pesos for non-banking financial institutions depending on the extent of operations.[9] Apart from the difficulty in designing capital-adequacy requirements in a sufficiently sophisticated way, this measure can have adverse effects on competition if capital requirements are excessively high as the number of economically viable financial institutions, and thus entry, may be limited. A recent piece of work by Barth et al. [2006], using a database of 150 countries, shows how raising capital requirements had no discernible impact on whether a country had a more developed banking sector (measured by the amount of credit extended to private firms as a proportion of GDP), had more efficient banks (measured by net interest rate margins and overheads) or was less likely to experience a banking crisis.

21. Besides, some of the financial markets have a ***licensing process*** by which potential entrants should apply for a licence to the appropriate financial regulator. This measure can cause competition problems if the entry criteria are not well defined and the process is not transparent enough as it would confer too much discretion to the sectoral regulator.

22. ***Fit in proper tests*** are checks to ensure that the directors and managers of the financial institution have both the incentive and the ability to monitor the actions of the institution. This is particularly important with banks as many conflicts of interest may arise if the links between banking and commerce are close.

23. Finally, there may be limits on ***foreign entry***. Again, this measure is targeted at protecting national incumbents, this time, from foreign competition.

24. In general, all these restrictions on entry provide for sufficient profit for financial intermediaries and assure other safety and soundness objectives. This is important because the existence of future profits will provide incentives for financial institutions to act prudently in the present (in other words, owners of financial institutions will behave more prudently if they have much to lose). The large-scale privatisation of the Mexican banking system in 1991-2 provides a good example of super-competition: "Marginal costs exceeded marginal revenue during the 1992-1994, thus weakening capital positions and increasing incentives for risk-taking of banks, and thereby contributing to the financial instability resulting in the 1994/5 crisis.[10]" Claessens and Klingebiel [2001], p.5

25. However, using entry barriers alone to manage the level of competition can have important negative drawbacks: large rent seeking; limited incentives for cost reduction and other efficiency improvements; and limited incentives for technological and other innovations.[11] Besides, there are the benefits that competition can bring; such as a reduction in corruption as broadening the scope of institutions able to provide payments services can reduce the political influence of incumbent banks. Furthermore, more competitive systems may also be more stable, provided entry involves a diversified set of institutions.

26. There is a second group of regulations that consist of restrictions on **pricing**, such as ***ceilings on deposit rates*** and ***control on fees***. The primary objective of these measures is to increase the profitability of financial institutions already competing in the industry and thus provide them with the appropriate incentives to act prudently. Moreover, the ***borrowing rate*** may also be controlled by holding it below its free-market level, which obviously is rationing credit to privileged borrowers.

27. Besides, there are **line-of-business** regulations that not only may restrict the ***ownership*** linkages among financial institutions but also with non-financial institutions. The restrictions on the links between financial institutions and non-financial corporations are targeted at avoiding possible conflicts of interest, such as lending to such corporations at non-market conditions. In Argentina, for instance, financial institutions are prohibited from owning more than 12.5 percent of industrial, agricultural, commercial or other kinds of non-financial companies unless specifically approved by the Central Bank. Such approvals typically involve companies whose activities are considered to be complementary to a financial activity. In March 2000, the list of activities considered as services complementary to financial services was expanded. In some instances, the approval of the Superintendent of Financial Institutions is also now required to acquire more than 12.5 percent of such a company.[12] Similarly, in Panama, a new regulation was issued in 2002 defining cumulative limits for investment by banks in other companies, which limits such investment in companies not related to or involved in banking business to no more that 25 percent of a bank's capital funds.[13]

28. There are also special rules concerning ***mergers*** between financial institutions, but this issue will be considered in more detail in section II.

29. Finally, the last layer of regulation involves ***monitoring and surveillance***. Regulators subject all financial intermediaries (whether they are banks, securities firms or insurance companies) to varying degrees of scrutiny which involves on-site examination of the institutions by the regulators as well as the production of accounting statements and reports on a timely basis. In some countries this supervisory role of the regulator extends to competition issues.

30. There are regulations that apply only to the **banking sector**, as it has been conventionally considered to be of special nature. There are two main reasons why banks are traditionally considered to be special: first, they provide credit to other firms and manage the flow of payments throughout the economy; and second, they are especially prone to failure due to, among other reasons, their high leverage and short-term funding structure. Although some of the market failures observed in the previous section are present in the banking sector, the official justification for banking regulation is the necessity of providing a "**safety net.**"[14] "The safety net generally consist of all or some of the following components: lender of last resort facilities, deposit insurance, access to payment systems, regulatory norms, supervisory policies and practice, intervention rules, insolvency-resolution policies and mechanism, and implicit protection (e.g. though restriction on competition). Safety nets tend to differ on the specific design of each element, the weight given to each *element within the whole, the interaction between elements, and the institutional arrangements that sustain them."* Claessens and Klingebiel [1999], p.27

31. The ***lender of last resort*** is an explicit or implicit policy that allows the central bank to assist the banks that are facing financial difficulties. It aims to reduce the risk of bank bankruptcies. If it is not implemented strictly in situations of temporary liquidity problems, it may incentivise financial institutions to take on too much risk. Restricting the access to ***payment systems*** may not be appropriate to all types of financial and non-financial institutions. The ***compulsory deposit insurance*** is a guarantee that all or part of a depositor's debt with a bank will be honoured in the event of bankruptcy. To that end, the bank pays a premium to a deposit insurance company[15] and in exchange its depositors have their deposits insured up to a fixed limit in case the bank fails. "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." Biggar and Heimler [2005], p. 9

32. Broadly, these measures are targeted at protecting the smallest depositors from a bank bankruptcy and at preventing bank runs. However, because from the point of view of the depositor, some of these measures make all banks equally safe, it removes the incentive on the depositor to determine the risk of the bank, to diversify his/her portfolio and to monitor the bank's behaviour. In other words, these measures tend to weaken the market discipline. Moreover, for the deposit insurance, 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." Biggar and Heimler [2005], p. 10

33. However, the special role of banks is being altered by the emergence of many substitutes for bank deposit and loan products (see the following section). In other words, banks are becoming less crucial to financial intermediation and stability.[16]

34. The main motivation for prudential regulation is to increase the solvency of the financial sector. However, it is usually understood that tighter regulation also leads to more concentration and higher spreads. Thus, these prudential measures may introduce a trade-off between solvency and competition.

C. The financial sector: a changing industry

35. In the last two decades, changes in the financial sector have not only changed the structure of the sector itself but also the way the financial service providers compete in the different financial markets.

36. First of all, the regulated financial services are facing increasing competition from other regulated products (for instance, there is increasing competition in the long term savings market from firms primarily based in the insurance, pensions, and securities industries) or from relatively unregulated products (mutual funds, brokerage funs, etc). There is a "global trend of increased substitutability between various types of financial instruments in terms of providing similar kind of services. Bank deposits, for example, compete now in many countries with other liabilities of financial intermediaries, such as money market funds, in the provision of liquidity and payment services." Claessens and Klingebiel [2001], p. 10. This new reality has driven some countries to formally remove the regulatory barriers separating banking, insurance and securities activities (see the following section).

37. Furthermore, non-financial entities, including telecommunication companies[17] and supermarket chains[18] are also entering the financial services market and the ties between financial and non-financial institutions have become more extensive.[19] This has implied, on one hand, that the demarcation lines between different types of financial intermediaries have become increasingly blurred from both consumer and producer point of view. On the other hand, the economic costs of maintaining regulatory barriers have risen as these barriers have become less effective, but still impose costs on individual financial institutions.

38. Some regulation has further become ineffective because of the development of various types of regulatory avoidance such as the proliferation of offshore financial centres and off-balance-sheet methods of financing.

39. Besides, advances in telecommunications and computers and the growth of the internet and wireless communication technologies are also changing the structure and nature of financial services. The range of financial services is expanding and now it includes e-wallets, electronic bill presentment and payment and many electronic business services. Additionally, new providers are emerging such as online banks[20] and brokers and companies which allow consumers to compare financial services such as mortgage loans and insurance policies. "These advances are leading to benefits for consumers and firms, with lower costs and better quality services. On the retail side, brokerage fees have fallen in many markets from upwards of $50 per trade to virtually zero. Internet-only banks have put pressure on margins of incumbent banks with higher deposit rates and more competition for loans. With better two-way communication channels, customers have more information and better transparency

about financial services and the process they are engaged in. The speed of services has also improved dramatically, as in online loan applications. (…) Transaction costs on securities are lower, as are search and monitoring costs for tracking corporate information and behaviour*"*. Claessens [2002] p. 7.

40. These advances in technology have made the internationalisation of the financial services possible, which is leading to greater competition between international financial services. For instance, in securities markets, global trading is becoming the norm. The globalisation of certain financial services, which has involved increased financial integration, increased cross-border mergers and acquisitions of financial institutions and lower barriers between markets, is also facilitated by the proliferation of international agreements.

41. In short and as stated in Cornett and Saunders [1999] p. xix:
"As we approach the turn of the century, regulatory barriers, technology, and financial innovation are changing such that a full set of financial services may again[21] be offered by a single financial services firm. Not only are the boundaries between traditional industry sectors weakening, but competition is becoming global in nature as well."

42. Thus, there is room to shift from the described structural regulation to a more market-oriented approach.

D. The regulatory reform: scope for more competition

Regulatory reform

43. Since the mid 70s there has been a significant process of regulatory reform in the financial sectors of most countries. In the Latin American banking sector, "legislative changes for banking reform were enacted in nearly all countries in the region. These banking reform changes allow us to classify these countries into three groups. In the first group, enacted new laws changed existing banking legislation drastically [Chile (1986), Mexico (1990), El Salvador (1991), Bolivia and Venezuela (1993), Ecuador (1994), Honduras (1995), and Paraguay and Peru (1996)]. *In the second group, including Colombia and Costa Rica, the legal reforms were not as drastic as in the first group; nevertheless, new legal provisions were enacted that altered substantially the previous structure in the banking systems. Finally, in the third group, new laws were issued that amended specific aspects of the legal framework for banking. This group of countries includes Argentina, Guatemala, and Uruguay. Additionally, Brazil instituted banking reforms through new regulati*ons." Philippatos and Yildirim [forthcoming], p. 3

44. Among the most relevant changes, there is, for instance, a partial or total decrease in the interest rate controls in the majority of the countries, thus finishing the forced situations of excess demand and supply. For instance, in Mexico, interest rate controls were eliminated in 1989, prior to the privatisation of the banking sector.[22]

45. Of particular interest is the relaxation of the line-of business restrictions as they respond to a great extent to the changes experimented by the industry (subsection C above). The new competitive reality has driven some countries to formally remove the regulatory barriers separating banking, insurance and securities activities. For instance, in 1999, the Glass-Steagall Act was repealed in the U.S. The Act had prohibited commercial banks from

collaborating with full-service brokerage firms or participating in investment banking activities. Similarly, in 2003 the Danish Parliament adopted a new Act on Financial Undertakings, which is a unified Act that compiles the specific provisions from various ad hoc financial legislations and includes commercial banks, savings banks, cooperative banks, mortgage credit banks, insurance undertakings, investments services companies and UCITS-managements companies (financial services companies). The aim of the joint Act was to ensure uniform treatment – a level playing field – of financial groups and to make various simplifications possible. Sometimes, the reform goes even further than simply eliminating the existent restrictions between sectors and for the shake of coherence, it merges the different sector regulators into one. For instance, in Peru, the Bank and Insurance Superintendence[23] was the body in charge of the regulation and supervision from the bank and insurance systems, and from 2000 on it also watch over the interest of those who are members of the Private System of Pensions.[24,25] Similarly, in 2005 Colombia placed the supervision of the banking and securities sectors under the same entity: the Financial Superintendence.[26]

46. The capital requirements regulation has also undergone some degree of reform in order to decrease the barriers to entry: for instance in 2003, the Argentinean Central Bank reduced the minimum capital requirement from 11.5 to 8%, over the value of financing and of non-fixed assets. But it is important to also take into account the problems created by this measure (see subsection B). For instance, "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." Biggar and Heimler [2005], p. 11

47. Another block of reform has been the reduction of restrictions on foreign entry. For instance, in Mexico foreign economic agents have been allowed to own 100 percent of the capital stock of Mexican banks since 1998.

48. In general, the regulatory reform has not implied a deregulation process but the introduction of a more market-oriented regulation. Therefore, regulation is increasingly based on the compliance of domestic financial systems with international formulated norms such as the "Basle Core 25 Principles for Effective Bank Supervision".

The new role of competition law and the competition authority

49. As highlighted in subsection D, the regulatory reform has opened the doors to more competition in the financial sector. In some countries, this change has enabled the competition authority to adopt a more active role in the sector. Similarly, the general competition law has seen increased its scope of application. Several different roles in the promotion of competition in the financial sector are discussed below along with examples.

50. A first group of countries can be distinguished in which the competition authorities are entitled to **apply competition law** (whether general or specific) to the financial sector. A recent example is provided by ***Portugal***, where a new independent Competition Authority was created by Decree-Law 10/2003 of January 18 and a new Competition Act was adopted.[27]

Contrary to the previous situation, in which the enforcement powers of the competition agencies were limited in certain sectors (for example, banking and insurance were not subject to merger control), the new Competition Authority has the power to apply any competition rules, in all economic sectors, within the limits of the Constitution, the law, and the competition policy principles approved by the government.

51. Similarly, in ***Mexico***, "[t] he LFCE [Federal Law on Economic Competition], in force since 1993, fully applies to the banking sector. Specific banking legislation does not contain dispositions on competition nor establish 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 [Credit Institutions Law] 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 [Ministry of Finance and Public Credit], which in turn will consult Banco de México and the CNBV [National Banking and Securities Commission]. The CFC may require information from financial authorities, but the analysis and resolution are independent of their decisions. The CFC [Federal Competition Commission] does not have veto over the CNBV's decisions or vice versa. 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." Appendix of Biggar and Heimler [2005], p. 59

52. In the same way, in ***Argentina***, since 1999 (when the current Law on the Defence of Competition was enacted), there have been no limits in the application of general competition rules to regulated sectors. Therefore, the National Commission for the Defence of Competition (CNDC) is the authority in charge of enforcing[28] the competition law in all the sectors. However, in some regulated sectors the regulator also has authority to deny a proposed merger on grounds other than competition. This is typically the case of the financial sector, where mergers should be approved by both the Central Bank and the CNDC.

53. It is important to mention the case of ***Brazil*** as it may be on the process of enhancing the role of the competition authority in the application of competition law to financial sector. The Law 8884[29] "applies to all private entities economy-wide and thus to companies operating in regulated sectors. The only exception to this principle has arisen in the banking sector (…). The Central Bank of Brazil (BACEN) has regulatory responsibility for bank and other financial institutions. It exercises "prudential" regulatory control over new bank charters and bank mergers; sets requirements for capital, reserves, and investments; and mandates internal control and accounting systems. Separate regulatory bodies exist within the Ministry of Finance for the insurance and securities sectors. (…) [A]lthough banking is not exempt from the competition law, "the Central Bank continues [to] exercise sole authority over competitive issues in the sector." In particular, the Bank has demanded exclusive control over bank mergers on the grounds that it must assure the proper disposition of "problem banks" and enforce constitutional limits on entry by foreign banking institutions*."* OECD [2005], pp. 83 and 90. As a result of the legal opinion issued in 2001 by the Federal Attorney General's Office, effectively vesting the Central Bank with sole jurisdiction over banks for all purposes, the Council for Economic Defence (CADE) has considered no conduct cases involving banks in recent years because the Secretariat of Economic Law of Ministry of Justice (SDE), as an

Executive Branch agency, is bound by the legal opinion and thus does not conduct investigations in the sector.

54. CADE has never acceded to that opinion and “negotiations between CADE and BACEN were undertaken to resolve the controversy by agreement. A consensus bill, sent to Congress in 2003 and approved by the House of Representatives' Constitution and Justice Committee in December 2004, is now pending before the full House. The bill provides that the Central Bank will have exclusive responsibility for reviewing mergers that involve a risk to the overall stability of the financial system. In all other merger cases, CADE will have dispositive authority. Authority for handling conduct cases in the banking sector will be lodged exclusively with the BCPS[30]. CADE and BACEN have long had a working agreement that is employed principally as a mechanism for exchanging information. On August 31, 2005, the two agencies signed an expanded agreement to promote cooperation and to elaborate a joint work plan for conducting merger reviews.” OECD [2005], p. 90

55. Secondly, the competition authority does not always have the decision power, but still may play a role as a **consultative body**. For instance, in ***Italy***, “the antitrust law provisions apply to banks but they are enforced by the Central Bank[31] (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.” Biggar and Heimler [2005], p. 22

56. This is also the case in ***Chile***. “Banks and some other financial institutions must notify the Bank Superintendence before merging, and the Superintendence could ask the competition institutions to review a matter. The parties to proposed mergers sometimes consult with the Prosecutor’s Office[32] in advance of closing, but consultation is at the discretion and timing of the firms. Parties to the largest and most important mergers rarely consult in advance with the Office.” OECD [2004c], p. 45

57. However, in not all countries does the competition authority play such an active role in the promotion of competition. Therefore, a last group of countries could be identified where the competition authority has **no decision power** and the implementation of the competition rules (whether general or special) is exclusively carried out by the financial regulator/s. In some cases, the relationship between the competition and prudential regulation is institutionalised, i.e. competition policy is explicitly delegated to the supervisory agency. This would be the case of ***Colombia***, where although the Superintendence of Industry and Commerce (SIC) is the main authority in charge of ensuring competition among commercial legal entities in the country, in the financial sector, SIC is relieved of its task by other entities such as the Superintendence of Banks[33] and the Superintendence of Securities.[34,35] Moreover, this sector is not subject to the "General Competition Regime", because a special competition regime is in place.[36]

The competition authority in charge of applying general competition law

58. Drawing on the country experiences and current sectoral changes, countries may want to consider the option of letting the competition authority be the body in charge of applying general competition law to the financial sector. The arguments that sustain this possibility are exposed in the remainder of this section.

The application of general competition law to the financial sector

59. The development of technology is reducing asymmetric information and economies of scale, which are some of the reasons for treating financial services differently from other products. However, reaping the benefits of technological innovations increasingly depends on the degree to which entry is allowed and uncompetitive structures are avoided. Therefore, the application of general competition rules is becoming both more feasible and necessary.

60. Similarly, technological advances, including the emergence of electronic finance, has increased the dependence of financial services on networks for their production and distribution (for example, trading systems, payment and clearing systems, ATM systems and informational systems), therefore they resemble to other network industries such as telecommunications or transportation and thus, a similar paradigm could be applied, instead of a "special" one. For example, payment services need no longer to be provided just by banks but could be provided by a range of corporations that have access to the payment network and infrastructure. However, the access to this payment system has traditionally been controlled by the incumbents[37] who have incentives to use their privileged position to foreclose[38] the market by charging high access fees to potential competitors. This issue, as well as many others that arise in the financial sector, are not more sector specific than the anticompetitive issues that arise in other sectors such as the telecommunication, transportation and energy sectors and therefore there is no reason to exempt the financial sector from the general laws that apply to other network industries.[39]

61. Moreover, as observed in subsection C, the regulated financial services are facing increasing competition from other regulated products, from relatively unregulated products and from non-financial products. Making all these products subject to the same general competition law seems to be the most appropriate way of creating a level playing field.

Competition agencies are the most adequate authorities to apply competition rules

62. First of all, competition authorities are better placed than specific-regulators to decide on competition policy issues, as they have more extensive experience in dealing with cases, such as mergers.

63. Moreover, competition authorities are less likely to be captured by the particular industry-lobbying group[40] and are typically less self-interested in continuing unnecessary regulations. "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." Biggar and Heimler [2005], p. 20

64. It is better if the implementation of the regulation addressed to avoid systemic risk and to ensure stability is done by a different authority from the one in charge of promoting competition as these goals may sometimes conflict. If the same authority is in charge of

implementing both objectives, it may not be efficient in doing so. "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." Biggar and Heimler [2005], p. 20

65. If competition policy is implemented by competition authorities, then they can take a more functional approach (i.e. applying principles to types of services and not type of institutions), which is desirable because it evens the playing field across providers for each financial services and across similar types of financial services.

66. Conversely, if sectoral regulators are in charge of enforcing competition policy, there is often a multiplicity of institutions charged with similar tasks, which would produce uncertainty among market participants as to which regulatory entity is actually in charge in their sector. This is especially true when one considers the existence of the many grey areas in which it is unclear whether a specific activity should fall under the authority of a sectoral entity or a competition authority. In addition, the multiplicity of authorities can generate a wide variety of interpretations of the law, which produces further confusion and uncertainty among economic actors and even the state entities themselves. This uncertainty manifests itself in bureaucratic delays that obstruct the flexibility required by the market to make decisions on economic competition.

67. To sum up, one of the best ways to obtain a competitive financial sector is to subject the financial services sector to general competition law and to strengthen the competition authority's role in overseeing the sector in question. Conversely, competition authorities should not tackle stability concerns which should be under the jurisdiction of financial regulators.

68. The different areas of relevance for the competition authority are: merger review, investigating the issues of market power and dominance of institutions and review of restrictive agreements.[41] In the remaining part of this paper two particular examples will be reviewed: the banking merger case and anticompetitive issues in the payment cards market.

III. The banking sector: merger review

69. A simple definition of a bank, used by many regulators, is the following:
"a bank is an institution whose current operations consist in granting loans and receiving deposits from the public." *Freixas and Rochet [1997], p.1*

70. However, a bank can undertake many other complex operations. The degree to which the banking sector is clearly differentiated within the financial sector is often determined by regulation and not competition. In this respect, there are countries (such as Canada, France and United Kingdom) where banks are allowed to engage in any type of securities and other non-credit financial service activities and there are countries (such as United States and Italy) where banks activities are more restricted.[42] In many countries of Latin America, banks are allowed to undertake securities activities; however, there are more restrictions when it comes to offer insurance products. Real Estate activities and bank investment in industrial firms are generally very limited or not permitted at all. See Appendix A for a detailed sample of Latin American countries.

71. For the purposes of this paper, "banks" will be treated as deposit taking institutions whose activities include substantial involvement in financial intermediation and may also include brokering functions.[43]

72. Having said this, then the problems that affect the financial sector as a whole stated in section II subsection A apply as well to the banking sector. The banking sector has, though, some particularities as highlighted by the particular regulation that only apply to it (see end of subsection B of section II).

A. Evaluation of bank mergers

73. "In recent years, Latin American banking sectors have experienced an accelerated process of consolidation that was accompanied by important increases in concentration and, in most cases, internationalization*."* Yeyati and Micco [2003a], p.2

74. From 1994 to 2000, the participation of foreign banks has more than doubled in Latin America while banking concentration is relatively high in comparison with EU and US standards.[44] In particular, from 1996 to 2002 the decline in the number of banks in the region's banking markets ranged between 21% to 32%.[45]

75. Reasons behind this decline in the number of banks include the regulatory reform[46] and successive changes in the sector such as the adoption of new information processing technologies that has increased the efficient scale of operation for some activities. For the case of Latin America, Yeyati and Micco [2003a] further specify that "banking sector consolidation in Latin America appears to have been based to a large extent on the acquisition of local banks by bigger foreign institutions. The main underlying reason appears to have been in part related to the lower perceived vulnerability to financial shocks. This, in turn, was induced by the typically larger capitalization of foreign banks and perceived liquidity insurance from highly diversified parent houses and solid lenders of last resort in parent countries, all in a context of financial volatility and frequent banking crises. This fact is not trivial in the analysis of competition: other things being equal, depositors tend to demand

higher returns from local banks than from their foreign counterparts." Yeyati and Micco [2003a], p.6

76. This concentration trend has raised concerns about its implications for the competitive behaviour of banks, and for the approach that the supervisory bodies should adopt to balance financial stability considerations with the goal of fostering competition.

77. The main negative effect of a merger is the creation of an environment that facilitates the exercise of market power, whether this is unilateral or coordinated. It is believed that bank consolidation generates a more concentrated system and, as a consequence, a less competitive one. However, there is no clear evidence that bank consolidation necessarily implies a less competitive banking environment,[47] as it may depend on the pattern of mergers. Therefore, a detailed case analysis is needed. The creation of market power in the financial sector may have particularly undesirable consequences such as a reduced access, for instance in small business lending, which may have a very negative impact in the economy. In order to assess whether this has happened or not, the relevant market should be defined. It is important to notice that besides the potential effects of the merger on competition, there are also risks of loss of industry stability, lack of soundness and safety of the new institution and lack of managerial competency.

Analytical framework

78. Prior to the evaluation of the effects of a merger is the definition of the relevant market, i.e. of the market where the merger is taking place. To rule out any irrelevant activity, the affected market is defined (by economists) as the smallest group of services in a geographical area that compete with each other to a sufficient degree. Services compete to a "sufficient degree" if they are seen as substitutes by customers and perform a similar function. Therefore if, when one of the services raises its price by a small but significant amount, many of its customers switch to other services to make this price increase unprofitable, the alternative services are said to exercise a "competitive constraint" on the service that raised its price.

79. Banks provide many different services; therefore the analysis of whether the new merged firm will have the ability to exercise market power is a complicated task. How to approach this analysis of a multiplicity of markets is the objective of the next section, where examples for two of the primary markets of concern in bank mergers will be provided. The following paragraphs set out the process of market definition and the evaluation of the competition in the relevant market.

80. One of the two dimensions of the **market definition** is the product. The first factor that must be taken into account in the drawing of the product boundaries 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." Because "(i)f such substitution would not occur in an amount sufficient to make the price increase unprofitable then the product constitutes a relevant product market." Biggar and Heimler [2005], p. 23. ***Demand substitution*** is an increasingly important issue as bank products and services are facing and ever-increasing competition from non-banking products, enhanced by the technological innovation. For instance, technology has reduced the transaction cost of investing in securities; this is the reason why certain forms of securities are increasingly competing with long-term deposits.

81. The Competition Authority will consider as well the ***supply substitution***, that 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[48]." Biggar and Heimler [2005], p. 23. Special attention should be paid to this analysis as other financial institutions and even non-financial institutions are increasingly competing with banks[49].

82. The third factor that should be analysed is the ease of ***entry***. As it has been previously observed[50,] a large variety of regulation hinders the entry of potential financial institutions. "For new services that are subject to less regulation, such as bill presentation or payment gateways for business-to-business (B2B) commerce, new entrants could easily innovate. Although deposit-taking and many traditional payment services exhibit large potential for commoditization – through online banks, payment services using pre-paid and "smart" cards – entry has been limited, in part because of regulatory barriers." Claessens [2002], p.6. Unfortunately, these are not the only barriers to entry that the sector may encounter, for instance, there are distribution networks and other essential facilities that may be susceptible of monopolisation.[51] The existence of switching costs and high fixed and sunk costs might constitute another barrier to entry.[52] Another issue to look at is whether the particular products can be easily commoditised: "(e)ntry has been particularly strong in financial services that can easily be unbundled and commoditised and that offer attractive initial margins. These include many non-banking financial services, including brokerage, trading systems, and some retail banking services." Claessens [2002], p.6. However, it is important to bear in mind that in many developing countries the picture tends to be rather different. Competition from other financial institutions and through other forms of financial intermediation is stronger in more developed markets therefore a concentrated market can potentially be competitive. The reason for this is that financial institutions in developed markets are faced with a credible threat of new entry as, firstly, entry is allowed, subject to certain conditions, and secondly the licensing process is transparent. This threat of entry is not always present in developing countries, where entry has been limited often due to regulatory barriers, especially for foreign financial institutions. Moreover, many developing countries differ from developed countries as exit processes for banks and other financial institutions have often been very weak, resulting in financial systems with many weakly and undercapitalised financial institutions and unfair competition. Therefore, developing countries "tend to have concentrated financial system that are also heavily bank-dominated, the degree of commoditization of financial services has been less as incumbents have mounted barriers and have faced less incentive to innovate themselves less." Claessens [2002], p.6. Moreover, "In considering barriers to entry in banking, particular attention should be paid to the extent to which electronic banking developments have reduced the need for extensive, expensive branch networks and lowered the cost of monitoring" OECD [2000], p.8.

83. As usual, once, the boundaries of the relevant market are drawn up, the level of competition should be assessed, since the characteristics of competition in the market will affect the likelihood of anticompetitive effects following the merger. For instance, in the banking sector location is a natural barrier, particularly in sparsely populated regions. Therefore, in the absence of competition banks serving the area may enjoy significant rents.

84. In this case, reducing the number of banks potentially serving the region may substantially increase the market power of the remaining banks. Equally important is the analysis of the

diversion ratio. "(I)f 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*."* Biggar and Heimler [2005], p. 23

An application

85. Banks sell a multiplicity of services that vary according to the country.[53] The most common services provided to personal consumers are deposits, personal loans, mortgages, credit cards and investment services. To business, banks usually sell deposits, loans and other type of external finance. Besides, banks may supply specialised services to other banks, often for resale to the ultimate purchaser such as trade finance, custody, check clearing services, and foreign exchange services. A bank merger does not negatively affect all these markets to the same extent; on the contrary, some will be more affected than others. For instance, concentration may lead to tacit collusion in credit card interest rates, given that typically there is a limited number of issuing banks. Access to ATM networks is another potential source of non-competitive practices, due to network externalities. However, there are two bank products for which competition concerns tend to be the greatest: small business loans and consumer bank products. These two markets are the focus of the remainder of the section.

86. There are two possible approaches to tackle this issue: a disaggregated analytical method that would consider the effect of the merger on each separate market and a cluster market approach that analyses the effect of a hypothetical market that encloses all the services provided by the bank. There is some controversy about which is the best method to use. Some people "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." Biggar and Heimler [2005], p.26. However, banks are not constrained to raise the prices of all the services they offer. Moreover, just because there is no overall indication of monopolistic competition does not imply that monopolistic practices do not appear in particular markets. Additionally, "[i]mportant differences in geographic markets would be missed (…) [and] grouping could lead to errors in assigning market shares. The competition provided by firms specialising in mortgages would be ignored, for example, if the market were defined to be a commercial banking cluster." OECD [2000], p.7

Small Business Loans

87. Small and medium-sized businesses account for 98% of all enterprises in Latin America.[54] Therefore it is very important for the region to provide appropriate credit to them. The most usual credit products for small business are mortgages on commercial property, and loans to purchase or lease vehicles, equipment and other capital goods. It is common among these businesses to rely on personal credit, such as general purpose consumer credit cards or a second mortgage on a personal residence[55.] A crucial question is whether banks are likely to raise the prices of small business loans following a merger.

88. If small businesses are able to substitute bank loans for other products, this is unlikely to happen. However, in developing countries, many firms do not have significant access to non-bank sources of external[56] finance.[57] In 2000, the Mexican competition authority acknowledged that it had not explicitly taken into account the potential competition between non-bank providers factoring and leasing services with other credit operations by banks in its

analysis of merger cases. [58] Moreover, due to the fact that loans to large businesses are larger than the ones to small businesses, large businesses are much more able to bear the substantial fixed costs associated with borrowing directly from national or even international capital markets as opposed to proceeding through a financial intermediary. Therefore, loans to larger businesses tend to have a wider set of product substitutes than do loans to small businesses. Additionally in developing countries, small businesses are particularly reluctant to switch loan suppliers due to the costs attached to establishing a new reputation for creditworthiness; as such information is not readily available to financial institutions. An existing relationship with a bank has been shown to be an important determinant of the success of a small business in obtaining a loan; in addition, small businesses that have had longer relationships with a bank pay lower rates to receive a loan from that bank, and face lower collateral requirements. For instance, Brazilian data for September 2004 shows that 67.04 per cent of the corporations have a credit relationship with only one bank (and 19.27 per cent with two banks).[59] Smaller banks in particular appear to specialise in such relationship lending to small businesses. This leads to the question of which banks are able to compete in the supply of small business loans.

89. Small businesses are very dependent on local banks. First of all, because larger businesses tend to take out larger loans, they are more willing to incur the fixed transaction and information costs involved in searching for and borrowing from more distant banks offering more favourable terms. Second, small businesses usually have a greater need for a local depository for cash and cheques. Moreover, a small business' ability to obtain bank credit on reasonable terms is more likely to be improved by locating its transactions accounts in the same bank it borrows from, as this would decrease the asymmetry of information about credit risks. Third, again as regards establishing creditworthiness, small businesses find it relatively more important to develop and maintain good personal relationships with bank loan officers. This is reasonably easier to do when the small businesses and bank are located close together. Yildirim and Philippatos [forthcoming] find for the case of Latin America that large banks in Argentina[60,] Brazil, Chile, Peru, and Uruguay operate in a relatively more competitive environment compared to small banks; or, by implication, competition is relatively lower in local markets compared to national and international markets. The authors suggest that a possible interpretation is that smaller banks can exercise some market power due to their strong competitive position in local retail markets and enjoy certain degree of spatial differentiation accompanied with it. The authors obtain the opposite result for Venezuela and do not detect any significant difference between small and large banks in Colombia, Costa Rica, Ecuador, Mexico, and Paraguay. With reference to the geographical scope of competition, Mexico for instance, has defined markets to be national,[61] because bank licences have a national dimension.[62] Although small businesses prefer local sources of supply, the national dimension of the market can be justified by using a chain of substitution connecting all local areas. An important caveat should be made at this point, since the development of Internet banking may broaden the geographic scope of competition in the future. "There is however evidence of convergence in e-finance across countries. (…) In Brazil, for example, on-line banking is more prevalent than in most developed countries." Claessens [2002], p. 6

90. Apart from the existing banks, can potential banks or other financial institutions easily enter the market if the price happens to increase? It has already been highlighted that entry sometimes is not easy due to regulation. For instance, in Mexico, "institutions competing with some of the services banks provide, such as savings institutions, do not have state provided deposit insurance, and some of them had experienced bankruptcy affecting its consumers. For this reason, consumers might view the services these institutions provide as imperfect substitutes for the services of banks. State provided deposit insurance might be an entry

barrier for deposit taking institutions other than banks." OECD [2000], p.195. Moreover, barriers to switching providers are perceived to be high which reduces the stake for potential entrants. The lack of information about credit worthiness of small business, together with the need to set up a physical network of offices, would further increase the barriers to entry.

Consumer banking

91. Consumer bank products include current accounts, home mortgages, car loans, credit card services and transaction services. Services to personal consumers are part of the retail banking, as services to small businesses do; therefore both groups of customers are affected by the same problems. Are banks likely to raise the prices of consumer banking products following a merger?

92. If consumers are able to substitute these products or easily change supplier, this is unlikely to happen. However, consumers may not be able to switch without difficulty. First of all, consumers may face considerable transaction costs. For instance in Mexico, "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." Appendix of Biggar and Heimler [2005], p.48. Furthermore, consumers may not be able to switch because they cannot easily obtain all the necessary information[63] to assess the services of different providers, or simply because the complexity of the products (i.e. many consumers tend to be unaware of details of financial services) do not allow them to compare. Additionally, customers favour obtaining most services from a single institution in order to maintain their established creditworthy reputation with the current bank. For instance, Brazilian data for September 2004 shows that 78.20 per cent of consumers have a credit relationship with only one bank.[64]

93. Like small businesses, consumers are very dependent on local banks (see above). "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." Biggar and Heimler [2005], p.25. For example, in Chile's financial system, 70 per cent of all consumer credit comes from retailers rather than financial institutions.[65] Consumers prefer to deal with a bank conveniently located, either from home or working place. Therefore, although competition takes place at a local level, the market can be defined as a national level because the localities will compete between themselves. The development of home banking via Internet and telephone may change the geographic scope of the market in the future.

94. As in the case of small business loans, entry into the market may not be easy because of the regulation, the switching costs that consumers bear and that will prevent entrants from attracting existent consumers, the lack of information about credit worthiness of customers and the need to set a brick and mortar points of contact with customers, among others.

B. The role of competition authorities in promoting competition in the banking sector

95. "In most countries, bank mergers are subject to review by prudential regulators as well as competition offices. To the extent both agencies act proscriptively rather than prescriptively, there should be little conflict between them. Formal co-operation accords exist in many

countries and have played a constructive role in reducing uncertainties associated with multiple agency review." OECD [2000], p.4

96. A Latin American country with strong involvement of competition authorities and the less involvement of financial supervisors is Mexico. "To give an example, let us consider a jurisdiction in which the financial sector is not exempted from competition law and where a merger between banks needs the approval of the competition authority. Such a merger can be blocked by the competition authority, even when the financial regulator would be in favor of the merger, e.g. with an eye on the improvement of capitalization ratio's that the merger would bring about. In such a case, the conflict between the two goals - economic efficiency/competition versus capitalization ratios - is resolved not so much by the institutional design of the competition authority within the Government but by the institutional design of what exactly are its competences and responsibilities in relation to those of other authorities, i.e. by the structure of economic governance in the country." OECD [2003], p. 4. For a particular case, see Box 1.

Box 1. Mergers in Mexico

BBV / Bancomer[66]

"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 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[67] guidelines.[68]

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[69]. 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." Appendix of Biggar and Heimler [2005], pp. 59-60

97. In Argentina, all mergers, including those in the financial sector, must be approved by the National Commission for the Defence of Competition (CNDC), but in any given sector the regulator may also have the power to control mergers. This is the case of the banking sector. Thus, both the CNDC and the Central Bank must approve bank mergers.

98. In Chile, the role of the competition authority in the financial sector became clear with a bank merger case, where it was argued that the bank supervision law exempted such mergers from the competition law. However, the applicability of the competition law was confirmed.

Box 2. Bank merger in Chile

"The competition institutions' handling of recent mergers in the banking sector also led some to question the institutions' view of the law's goals. A merger of two large Spanish banks that also operate in Chile gave the merged firm 27 per cent of the national market. The Prosecutor's Office challenged the merger as anticompetitive. The action led to a dispute over whether Chile's bank supervision laws created an implied exclusion from the competition law. The Antitrust Commission found that it had jurisdiction to consider the merger, but also found that the merger was not anticompetitive. This outcome may have been influenced by the enactment of legislation[70] permitting easier entry by banks." OECD [2004c], p. 23. "Since the Spanish banks case was decided, the Banking Superintendency has acknowledged the competition institutions' authority to address competition issues in the sector. In addition, new legislation governs the circumstances when approval by the Banking Superintendency is needed and the procedures for that process." OECD [2004c], p. 53

99. At the other extreme, there are Brazil, Colombia and Peru. As mentioned in section II, subsection D, in Brazil, the Central Bank has full responsibility over bank mergers (both for stability and for competition considerations). Although a major involvement by the competition authorities may arise in the near future.

100. In Colombia, all transactions between financial entities are subject to control of the Superintendence of Banks (all financial entities, depending on the resulting entity after the merger), the Superintendence of the Social Economy (all co-operative financial entities), the Superintendence of Securities (all entities whose stock is registered with this Superintendence), or the Superintendence of Companies (for specific actions of the stockholders, partners, or the board of directors, or for insurance and reinsurance brokers).

101. In Peru, the Free Competition Law does not even apply to mergers[71] or acquisitions (i.e. it does not have provisions that require advance notification of mergers or acquisitions, nor does it ban mergers or acquisitions that are or are likely to be anticompetitive). However, since 1996, there is another law[72] which establishes a merger control regime exclusively for the electrical sector; this law is also enforced by the competition authority. [73]

102. In conclusion, the case of mergers needs special attention because mergers in general are part of the responsibility of the national competition authority (if there is one) and sometimes the central bank also plays a part in the decision. The optimal division of labour in the case of merger approval should involve the supervisory agency based on its expert knowledge of the financial sector, and the competition authority, on an equal footing with each other. In particular, the competition authorities have the competencies necessary for undertaking the competition review, while financial regulators should focus on prudential reviews.

IV. The case of payment cards

103. The payment card industry includes credit cards[74], debit cards[75] and charge (or stored value) cards[76]. These cards differ in terms of the underlying technology, pricing schemes and services, but are similar in their cash substitute function[77]. Payment cards can be seen as bundles of different services like Automatic Teller Machine (ATM) cash withdrawal, payment service at point-of-sale (POS) terminals and payment service over telephone or internet (using the credit card's numbers).

104. Latin America's card-payment market is growing exponentially, with MasterCard and Visa reporting strong growth rates for 2005, particularly in Brazil and Mexico, where card infrastructure is being built up. Credit card penetration grew by almost 20 percent annually in some Latin American countries over the past five years, and now runs at 40 percent in Brazil and Argentina.[78] In developing countries, the use of payment cards not only brings the usual benefits attached to boosting consumption (and thus economic growth), but also other benefits such as the increase in the size of the formal economy (due to the registration characteristics of this payment instrument as compared with cash) and the assistance in tax collection[79].

105. In considering card networks the two main activities are the issuing of cards and the provision of merchant acquisition services. The infrastructure organisation that coordinates both activities usually can take two different forms. In some cases, these activities are undertaken by different parties, that is, the card-issuing bank that oversees the issuance of the credit card and the acquiring bank that acquires the merchant transactions. In these cases, the coordination between these parties is done through the creation of joint ventures by banks (e.g., Visa, MasterCard). In other cases, both activities are undertaken by a sole party: the card issuer/processor that integrates the issuing bank and acquiring bank activities (e.g., American Express, Diners Card). Payment cards can be also issued by non-banks, but these retail cards often have a limited acceptance[80].

106. In the first type of organisation (also known as four-party system[81]), "the merchant typically contracts with an external company that "acquires" the transaction. Through a terminal, the merchant communicates the amount of the transaction and the consumer card information to the acquirer. The acquirer will then consult the payment platform, which will, in turn, consult the issuer for verification that sufficient funds remain available to the customer for the transaction. [82] Assuming the funds are available, the transaction may either be authorised immediately or the issuer may require that a phone call be made to confirm the transaction prior to issuing an authorisation." Ennis [2006], p.5

107. In the second type of organisation (also called proprietary or three-party system[83]), "the process is similar to that for a four-party system, but the number of steps is smaller. As before, the merchant typically contracts with an external company that "acquires" the transaction. Through a terminal, the merchant communicates the amount of the transaction and the consumer card information to the terminal processor who then communicates the consumer and transaction information directly to the payment platform. The payment platform performs both the role of acquirer and issuer. Assuming the funds are available, the transaction may either be authorized immediately or the issuer may require that a phone call be made to confirm the transaction prior to issuing an authorization." Ennis [2006], p.6

A. Anticompetitive issues in the payment card market

108. The market of payment cards is mainly affected by two market failures: externalities and market power. The main type[84] of **externalities** that are present in this market are network externalities as the whole system relies on the payment card network. There are direct externalities because the payment card users are positively affected by an increase in the size of their network, therefore, all else equal, a new user is willing to join the largest network if there is a choice (assuming that networks are not interconnected). The card user's choice may depend on initial first mover advantages[85,] and thus, it is not necessarily the firm providing the highest quality that becomes dominant. These direct externalities coexist with indirect ones, which come from the fact that the two markets are complementary: both consumers and merchants benefit from the fact that the other side of the market has adopted cards. [86] Because of this feature, higher competition between service providers does not necessary deliver better outcomes.

109. As a result of these externalities, the pricing practices in the industry are very sophisticated, as they may involve one side paying the other side to participate, despite both sides benefiting from the participation of each other.[87] Therefore, in principle, the price will not correspond to the underlying cost, and as a consequence, there may be a disproportionate use of high-cost payment systems.

110. The main pricing practices that have raised anticompetitive concerns in many countries are: interchange fees and merchant fees. The ***merchant fee*** is the fee paid by the merchant to the acquirer and it is also known as merchant discount. "Merchant fees for each payment platform are ultimately negotiated with the acquirer. Fees vary depending on the type of transaction (PIN[88], signature, phone, Internet), the sector of the merchant (travel and leisure sectors may face higher fees than grocery stores), the size of transactions, and, more generally, the risk-levels of the transaction." Ennis [2006], p.8

111. In the four-party payment platforms, there is typically an ***interchange fee*** paid by the acquirer to the issuer. This fee tend to change from one business activity to another and depending on whether the transaction is domestic or international and it is usually lower for debit cards than for credit cards. For three-party systems, there is no visible interchange fee, as a single institution encompasses both the acquiring and issuing function.

112. The other market failure is the existence of **market power**. The reasons why existing payment platforms enjoy market power are various, among which it can be found the presence of network externalities described above or the existence of essential facilities. In particular, because of the existence of externalities, entry may be difficult and slow as it may be costly to invest in developing appropriate network size. Besides, the major schemes have become essential facilities[89] since an "individual retailer cannot easily refuse to accept the cards of major schemes, because doing so would lead many consumers to shop at competing retailers, losing otherwise profitable business." Ennis [2006], p.19. Sometimes not only major schemes may enjoy market power but also, "cards with a small market share may still have significant market power, in the sense that a given retailer may feel unable to refuse to accept the cards[90.]" Ennis [2006], p.20

113. The existence of market power in payment system permits the implementation of anticompetitive practices such as excessively high surcharges and interconnection fees leading to de facto incompatibility, implementation of anticompetitive policies such as the no-

surcharge and the no-discount rules, discriminatory access against specific types of institutions and exclusive access to potential members, including forbidding simultaneous membership. These practices are explained in more detail in the following paragraphs.

114. Since the merchants have to bear the cost of the merchant fees, when possible, they try to pass it on to consumers by surcharging customers who use a card or offering discounts to customers who do not use a card. The ***no-surcharge rule*** and the ***no-discount rule*** prevent the merchant from respectively implementing these practices.

115. There are other rules that may have an adverse effect on competition, for instance, some systems have required that all branded payment cards must be accepted, once one card of this brand has been accepted. For example, once the credit card is accepted by the merchant, the debit card should be accepted too, or once the domestic card is accepted, the international card too. This form of tying is known as the ***"honour all cards" rule***.

116. Other anticompetitive issues have arisen within the payment card associations that form many platforms and who have agreed upon operation rules such as the requirement of ***exclusivity***, i.e., members can not join rival networks, and sometimes, can not even issue cards from competing networks. Exclusivity arrangements can lead to the predominance of a large network, even when more differentiated networks could proliferate and can limit the ability of the bank to increase the product diversity (i.e. to offer different types of cards), by preventing it to join networks of differentiated cards. Other restrictions attached to the association member status may include characteristics of the entrant institutions (for instance, only regulated financial institutions are accepted).

117. Moreover, the governance structure of the main four-party systems may be a source of anticompetitive issues itself as "card associations are owned by their member banks and pricing decisions are taken by boards representing their member banks, often with a proportionately higher representation for card issuers than acquirers." Ennis [2006], p.30.

118. Finally, antitrust actions can also involve the blocking of large horizontal mergers that would create a dominant network operator.

B. Latin American antitrust cases

119. In Latin America, electronic payment instruments were introduced throughout the region in the 1990s in an unregulated environment and banks and card associations were able to set policies and price schemes freely to their convenience.[91] However, regulators and competition authorities are starting to take a more active role in the scrutiny of anticompetitive issues in the market.

120. Among the most common cases, there are the excessive and/or discriminatory interchange fees, which are being challenged or investigated in many Latin American countries, including, Colombia, Mexico and Brazil.

121. In Mexico, the Bank of Mexico[92] found that the distortions occurring in the payment card market were substantial. In particular, it found that the Mexican market was underdeveloped[93] and that the usage of debit cards at POS was restricted, mainly as a result of the interchange fee (IF), which was set in a neither public nor transparent process by the Mexican Bankers

Association (ABM).[94] For instance, the interchange fee for debit and credit operations was the same until 2004, which "may have promoted a higher cost means of payment (credit card) at the expense of a cheaper means (debit card)." Negrín [2006], p.254. Moreover, "IF schedule had remained constant for the last five years though several related costs, like funding and data processing, had gone down very significantly in that period. This meant that cost considerations were absent from IF setting." Negrín [2006], p.254

122. In Colombia, a similar problem was tackled in a very different way. Although in Colombia, neither the general competition law nor the competition authority have any effect in the financial sector, the case of payment cards was approached by the general competition authority, the Superintendence of Industry and Commerce (SIC). SIC found that the interchange fee fixed by Credibanco Visa with the card Crédito was overestimated by more than 70 per cent, to the detriment of consumers. As a result, Credibanco will need to exclude the criteria and costs actually included in the computation of the fee that would not correspond exclusively to the payment card services offered to the merchants.[95]

123. Another cause for concern has been the high and extremely discriminatory merchant fees. In Argentina, before the enactment of the Law 25.065 of Credit Cards in 1999, the merchant fees could range from 1% for gasoline establishments and 2% for supermarkets to 10% for small shops.[96]

124. In Chile, the anticompetitive issues are mainly consequences of the industry's organisation as there is only one credit card network.[97] Association in the market was originally permitted with the objective of taking advantage of the potential scale and network economies and sharing the risk and the cost of innovation and development.[98] Association was allowed for the case of Redbanc, an ATM network, Transbank, a credit and debit card management and merchant affiliation network, and Nexus, a transaction processing and billing network. In particular, Transbank played the acquirer role in Chile for all credit card issuers (i.e. all banks and all card brands), that is, it managed the relationship with affiliate merchants and had a contractual agreement with merchants to process credit card transactions, including transaction validation and approval as well as reimbursing the merchant. Currently, there is just one debit card in Chile, and like with credit cards, the acquirer role was given to Transbank and banks retained the issuer role.[99]

125. As Transbank freely performed the acquirer role for all banks and all card brands[100], merchant acceptance was the same for all of them; therefore, there was little room for product differentiation. Moreover, the collaboration on the "acquirer side" could potentially decrease the rivalry in the competitive "issuer" side. Optimally, the monopolist Transbank should have acted as a mere "switch" that interconnects all the POS, however, it was involved in commercial activity. Transbank implemented a merchant fee scheme that was not justified on costs, for instance, there was no price difference in the fee between a debit and credit card. The price was varying from merchant to merchant in function of the business size in a range that decreased in 2003 from 1% - 6,5% to 1% - 4,5%[101.102]

126. With reference to the restrictive clauses attached to the contract with the merchants, in 1993, the Mexican "Competition Commission reached an agreement with a number of banks, by means of which banks could not forbid in their acquiring contracts that merchants offer *discounts* for cash payments.[103] Hence, many small stores and even some large merchants provide discounts for cash payments." Negrín [2005], p.253. However, card associations still set the "rule in *less than mature markets* by means of which only issuers can become

acquirers (…) [which] clearly constitutes a barrier to entry to the acquiring market." Negrín [2005], p.253

127. In Argentina, American Express reported to the Competition Commission that Visa and Mastercard were implementing an exclusivity rule according to which their members would have been automatically expelled should they issue American Express or Discover cards.[104]

128. Collusion has also been present in the Colombian market. The processing nets, Credibanco and Redeban Mutlicolor were accused of colluding to set the interchange fees higher than market value.[105]

129. Finally, there have been some cases of mergers and acquisitions involving payment cards. For instance, in Brazil, on 20 March 2006, Banco Bradesco, Brazil's largest private bank, said it would buy the local operations of U.S.-based American Express, assuming the company's card and payments-related operations in Brazil, for USD 490 million.

C. What role has been played by the regulator and the competition authority?

130. At the time when electronic payment instruments were first introduced in Latin America, there was no regulation in force. Since then, regulators and competition authorities have intervened in order to reduce the anticompetitive problems perceived in the market[106].

131. In Mexico, both the competition authority[107], the Federal Competition Commission, and the regulator, the Bank of Mexico, have legal authority to intervene in the payment card market. However, it is the Bank of Mexico which has taken a prominent role in addressing credit and debit card issues[108.] The Bank of Mexico found that the distortions that occurred in the payment card market were substantial enough for it to intervene. In particular, it modified the honour all cards rule so that merchants decide whether to accept only credit cards, only debit cards, or both. With respect to the interchange fees, the Mexican Central Bank has not issued any regulation.[109] These fees "are set by the Interchange Rates Committee of the Mexican Banker's Association, created in 2005. The Central Bank has observer status in this committee, and exerts influence by suasion rather than by regulation". Ramirez [2006], pp.3 and 4. The Mexican Banker's Association has reduced both debit and credit interchange fees, and has introduced several categories of interchange fee that discriminate by type of business, which promotes entry of previously non-covered segments of the market.[110] Therefore, due to the regulation, the interchange fees have declined in Mexico.[111]

132. Argentina also opted for a regulatory solution. At the end of the 1990s, there was a high variability in the merchant fees applied to different vendors. The fees ranged from 1% for gasoline establishments and 2% for supermarkets to 10% for small shops.[112] These pricing practices, together with high administrative charges attached to the issuance of payment cards and the highly variable interest rates for unpaid balances, motivated the enactment of the Law 25.065 of Credit Cards[113,] which establishes norms that regulate various aspects related to the credit, debit and retail cards system, such as the relationship between the cardholder and the card issuer or the relationship between the card issuer and the merchant. Among these norms, there was the setting of limits on the ability to implement price discrimination in the merchant fees.[114]

133. In Panama, between June 2003 and July 2004, the Superintendence of Banks, under the 1998 banking law, issued regulations for banks that issue and manage credit cards. It established, among others, the procedure for approving a credit card and authorised the charges for commissions and other related items.[115]

134. However, not all the countries have opted to introduce new regulation. For instance, in June of 2004, the Colombian competition authority[116] passed resolutions 6816 and 6817 of March 31, through which Colombian banking institutions proposed a new system to determine the fees dispute. The same authority passed the new Inter-banking Exchanging Tariff that allows merchants to negotiate the fee rates with the merchant acquirers. This new system is intended to exert a downward pressure on the fee, resulting in greater merchant acceptance.[117]

135. In Brazil, it is the Brazilian Competition Policy System[118] that has competency to investigate anticompetitive issues in the payment card market.[119]

136. Finally, in Chile, it has been the Antitrust Commission who has attempted to introduce more competition and transparency in the credit card market; however, it has adopted a more self-regulatory approach. On the 12 September 2005, the Chilean Antitrust Court admitted a complaint filed by the National Economic Prosecutor[120] based on an abuse of a dominant position by Transbank, the handler of credit and debit cards issued by banking institutions (see the previous section), imposing a fine of approximately USD 56,000. The National Economic Prosecutor required, among other things, the modification of Transbank price structure in such a way that it would be public, objective and based on costs, which was finally solved with a partial understanding between the parties. According to this understanding, Transbank had to reduce the merchant fees ceilings and to present a self-regulating plan for setting the prices.[121]

137. "One advantage of regulatory approaches is that regulators have a greater potential to be "forward looking"[122.] That is, antitrust law requires a perceived breach of the law in order to motivate action. Many activities in the area of payment systems may not constitute a breach of law, despite market deficiencies. Consequently, competition authorities may not have an ability to act. In contrast to competition authorities, regulators may act in the absence of a breach. Such flexibility could, generally, lead to excessive action were authority to be misused but also could be the only feasible way to deal with harmful conduct that is not illegal." Ennis [2006], p. 45

138. However, special care should be paid in developing countries as regulation may create undesirable effects if the particular country market conditions are not taken into consideration. Regulation not only may discourage the investment in developing the payment network but also may undermine the efforts to extend card penetration to all the population. This is particularly important for developing countries as the optimal network build-out has not been typically achieved. In an environment where credit rating systems are poorly developed, banks may be more cautious when issuing cards to consumers, if they are forced to decrease the transaction fees. For instance, in Argentina, following the introduction of the Law of Credit Cards, the criteria for issuing credit cards became stricter, and banks, instead of asking for a minimum working period of half a year as before, started to ask for a whole year period.[123] In the same way, the investment in the network maintenance and development may be affected. "In Mexico, the ABM [Mexican Banker's Association] has addressed the problem of expanding the electronic payments system to smaller merchants with its "Terminalization Fund", which aims to extend the POS network by 300,000 units placed in

small and medium-sized businesses. This is a voluntary initiative, and is taking longer to implement than originally conceived. Delays are attributed to fears that future regulation could jeopardize these investments, by compromising acquirers' ability to recover their investments in electronic payment technologies. (…) In Brazil's state of Sao Paulo alone, more than $55 million was spent on POS terminal, ATM and network technologies between 2004 and 2006. Further investment is required to keep the momentum going, and as in Mexico, potential regulations are seen as an obstacle to the payment system reaching maturity." Ramirez [2006], p. 4

139. As observed, in many countries, competition authorities have taken the most prominent action in this area. This may be the result of regulatory inaction, whether because regulators do not exist or are unable to take action. Therefore, in those cases, the competition authority powers act as an essential supplement to regulation.

V. Conclusions

- Given the changes that the financial sector has experienced (and is still experiencing), the application of a general competition law by a competition authority is more beneficial than the application of the competition law by a sector-specific authority or the exemption of the sector from the general competition law.

- Countries need to consider the possibility of letting the competition authorities be in charge of watching over and promoting competition in the financial markets while letting financial regulators ensure the financial stability of the sector. This task division does not exclude close collaboration when necessary.

- In the bank merger analysis, the previous conclusion translates into the competition authority investigating whether the merger would lead to an environment that could facilitate the exercise of market power, unilateral or coordinated; and the banking regulator analysing whether the merger is a threat for the stability and reliance of the banking system.

- In its task of watching over and promoting competition in the financial sector, the competition authority should employ the usual tools of antitrust analysis, which have already been proven effective in the analysis of anticompetitive issues in other markets and for which the competition authority has plentiful expertise.

- In markets with little regulatory burden or where the regulator has no direct competencies such as the payment card market, the intervention of the competition authority may be a successful solution to deal with anticompetitive issues.

Notes

1 See World Bank [2001].
2 Ideally, a perfect competitive setup refers to the market structure in which: (1) there are large number of small producers and consumers that behave as price takers, (2) the goods or services offered are perfect substitutes, (3) the producers and the consumers are well informed, (4) there is complete mobility of resources between alternative uses, and (5) any firm may enter or exit the market as it wishes.
3 The failure of one bank leads to a decline in the value of the assets sufficient to induce the failure of another bank. See Biggar and Heimler [2005] for more information.
4 The failure of one bank leads to the failure of another fully solvent bank. See Biggar and Heimler [2005] for more information.
5 If 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. See Biggar and Heimler [2005].
6 Sunk costs are costs that have been incurred and cannot be reversed.
7 Fixed costs are expenses whose total does not change in proportion to the activity of business.
8 Note that there are other reasons why financial institutions may exert market power. For instance, financial institutions typically bundle financial service together because they can derive their comparative advantage from the bundle of services they provide. This practice gives room for cross-subsidisation that may create barriers to entry in some of the markets if it is used as a predatory strategy. Therefore, open entry in one market entry in one market segment may as a consequence not guarantee a competitive market for that specific product. However, these strategies do not justify regulation *per se*, as this can be avoided through competition policy. Section II will deal with these issues in more detail for the banking sector.
9 For instance, it takes into account the concentration of loans and deposits, loans and deposits per capita, ATMs, and branches. See Institute of National Bankers [2005].
10 For more information on this case, see: Gruben and McComb [1999]
11 See Honohan and Stiglitz [1999].
12 See Institute of National Bankers [2000].
13 See Institute of National Bankers [2002].
14 See Freixas and Rochet [1997] for a more extensive discussion.
15 In the U.S., the deposit insurance company is the Federal Deposit Insurance Corporation (FDIC), who monitors and regulates participants in both Bank Insurance Fund (BIF), who provides guarantee funds for banks, and Savings Association Insurance Fund (SAIF), who provides guarantee funds for saving and loans. The provision of guaranty funds is not exclusive to the banking sector. For instance, in the U.S., the Security Investors Protection Corporation (SIPC) provides guaranty funds for securities firms.
16 In Chile, pension funds, which competed for resources with banks, forced banks to increase their efficiency and lower spreads (which tends to encourage the expansion and development of financial intermediation). Fuentes and Basch [1997].
17 Telecommunication companies can provide small payments services using the balances many mobile phone users carry on their pre-paid calling card.
18 Probably, one of the most recent examples is provided by the retailer Wal-Mart's bid for a banking license in the U.S. Despite the giant retailer's demand is only to open an industrial loan company, the financial sector is very opposed to this entry. See, for instance, The Economist, April 22nd 2006, "Resisting Wal-Bank", New York. Moreover, supermarket chains can easily provide payment services to their customers in their discount stores. For instance, in November 1999, Ito-Yokado, a nationwide supermarket chain, revealed plans to establish a bank specialized in payment services in Japan. The new bank will install ATMs in supermarkets and convenience stores of Ito-Yokado to process payments. The bank will not make loans to companies, but will invest exclusively in government bonds and similar instruments.
19 For instance, many banks have entered alliances with retail chains to distribute financial services.
20 On March 30, 2000, Sony announced plans to establish an internet bank.
21 The word "again" makes reference to the fact that originally the banking industry was operating as a full service industry performing directly or indirectly all financial services.
22 Appendix of Biggar and Heimler [2005].
23 Superintendencia de Banca y Seguros.
24 Sistema Privado de Pensiones.
25 See Law 27328.
26 Superintendencia Financiera.

27 Law 18/2003 of June 11.
28 The CNDC has such powers because the Tribunal for the Defence of Competition has not yet been enforced; however, its decisions must be ratified by a secretariat within the Ministry of Economy and Production.
29 The main Competition Law of Brazil.
30 The Brazilian Competition Policy System (BCPS) is composed by the Council for Economic Defence (CADE), the Secretariat of Economic Law of Ministry of Justice (SDE) and the Secretariat of Economic Monitoring of Ministry of Finance (SEAE).
31 Banca d'Italia.
32 It is the enforcement agency which has an important quasi-judicial body and is often referred to as the Antitrust Commission.
33 Superintendencia Bancaria.
34 Superintendencia de Valores.
35 This organisation is common to other sectors, notably, the Public Residential Services, Telecommunications, Television, Health, Maritime Transport and Aeronautical Sectors.
36 The special regime is contained in the Financial System Organic Statute (Decree Law 663 of 1993) and its amendments, which contains sectoral guidelines and grants the regulators the power to oversee, control, and sanction non-compliance of its rules and anti-competitive conduct by sector participants.
37 In recognition of this problem, in 2002, Canada reformed its federal financial sector legislation to expand the access to the payment system to accommodate the entry of the life insurance companies, securities dealers and money market mutual funds. Permitting these new types of financial institutions to join the payments system enable them to offer a range of services to their clients, thus promoting increased competition for the consumer's business. For example, life insurance companies would be able to offer payment services that are basically similar to those provided by banks or deposit accounts.
38 For instance, the U.K. market is affected by some of these problems: "Money transmission services are supplied in the UK through a series of unregulated networks mostly controlled by the same few large banks who in turn dominate the markets for services to SMEs and personal customers. This market structure results in the creation of artificial barriers to entry, high costs to retailers for accepting credit and debit cards, charges for cash withdrawals up to six times their cost, and a cumbersome and inflexible payment system that is only slowly adapting to the demands of e-commerce." Don Cruickshank [2000] p. viii
39 See Cleassens [2003] for more detail.
40 In developing countries, the pay of regulators is often insufficient which opens the door to corruption. Barth et al. [2006], using a database of 150 countries, find that strengthening supervision had a neutral or negative impact on banking development, reduced bank efficiency and increased the likelihood of a crisis.
41 For instance in Peru, the "financial sector (and some banks, indirectly) have been involved in two of Indecopi's recent price fixing cases – the automobile insurance case, in which price fixing was confirmed, and the ongoing case involving price fixing by pension fund managers. It has been suggested that the banking industry itself (including the Banking Association) merits closer scrutiny by the Free Competition Commission." OECD [2004a], p.61
42 For more detailed information, see Institute of International Bankers [2005].
43 Among the traditional banking products, it can be found checking, mortgages, brokerage, insurance and credit card.
44 This information refers to the following Latin American countries: Argentina, Brazil, Chile, Colombia, Costa Rica and Peru.
45 Yeyati and Micco [2003a,b].
46 See section II subsection B.
47 For instance, in a sample of eleven Latin American countries for the period 1993 to 2000, Yildirim and Philippatos [forthcoming] find that increased market concentration does not impede the level of competition in the region's banking markets. Furthermore, they find that a higher degree of foreign bank participation is associated with higher level of competitiveness and efficiency in domestic markets and reduced bank margins and profitability. These results are broadly in line with Yeyati and Micco [2003a] who report that seven banking sectors in Latin America (except Colombia) have moved towards higher competition in recent years.
48 Note that this is the second dimension of the market definition.
49 See section II, subsection C above.
50 See section II, subsection B.
51 In Chile, one interesting monopolisation case "involved a firm with an exclusive right to operate the system for handling inter-bank payments by internet. Access to the firm's system was required by any firm wanting to provide internet bill-paying services, and the firm itself had affiliates offering those services. The Banking Superintendency's rules provided that in order to offer services using defendant's system, a firm had to have a contract with a bank – thus in a sense making the banks responsible for the firms that offer internet bill-

paying services. The firm denied a new entrant access to its "essential facility" even though it had the required contract with a bank, and this action was found to have illegally created entry barriers." OECD [2004c], p.44

52 See section II subsection A.

53 In some countries banks are restricted in their ability to offer underwriting services, insurance, and some investment products, see appendix A for more detail.

54 Source: http://www.corporate.visa.com/md/dl/documents/downloads/modernisation/me-lac_devbanks.pdf

55 In Mexico, bank financing is mainly based on collateral guarantees such as a person providing a surety or real state. See the Appendix of Biggar and Heimler [2005].

56 In Brazil, from the 661.753 companies listed at the Public Credit Register, only 359 companies traded at Bovespa, the largest Brazilian Stock Exchange. See the Appendix of Biggar and Heimler [2005].

57 It is important to acknowledge the development of specialised lending institutions that use unconventional methods to lend successfully to the poor, known as micro-credits. "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." Biggar and Heimler [2005], p. 16. A Latin American example of such institutions would be Banco Sol in Bolivia that by 2002 became the largest institution in Bolivian financial markets interms of the number of loans contracts with an outstanding loan portfolio of $ 67 million. See Santos [2003].

58 See OECD [2000].

59 See the Appendix of Biggar and Heimler [2005].

60 Since larger banks tend to be foreign banks, these results are in line with Clark et al. [2000] who find that foreign banks in Argentina provide financing to SMEs on an equal or better basis than local banks.

61 Note that contrary to the markets where small business are involved, credit to large corporations and reinsurance markets usually will surpass national boundaries.

62 OECD [2000].

63 For instance, in Chile, the Commission had to instruct department stores and other suppliers of retail credit to adhere to the same interest rate disclosure rules that the Superintendence of Banks imposed on financial institutions within its jurisdiction, in order to prevent unfair competition by providers of credit that were not covered by the Superintendence's rules.

64 See the Appendix of Biggar and Heimler [2005].

65 See OECD [2005].

66 CNT-54-2000.

67 Federal Competition Comission.

68 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.

69 Credit Information Societies.

70 Chile adopted a new banking supervision law in 1997 to modernise the sector.

71 There is a bill pending to be approved by the executive branch, which is facing strong opposition. ICN [2006].

72 Law Nº 26876.

73 OECD [2004a].

74 These cards permit balances to be rolled-over from one month to another.

75 These cards are linked to a checking account and result in either an immediate or delayed deduction from the account.

76 These cards are loaded with a certain amount of money with each purchase amount deducted from the card.

77 Other payment instrument substitutes are cash and checks.

78 ePaynews [2006 a,b].

79 There are other reasons why credit cards may have a positive effect on the economy. For instance, sometimes processing small business loans is too slow and cumbersome for clients. In response to this problem, in May 2002, the Economic Development Bank (EDB) for Puerto Rico "launched the CrediAgrícola Visa card with a

credit line of up to US$25,000 and an interest rate tied to the US prime rate. The CrediAgrícola card enables farmers to purchase vital machinery and supplies." Visa [?]

80 Usually, retail cards account only for a small share of the market; however, this is not the case of Chile, where more payment cards are issued by retailers than by banks, given a distinct reluctance of consumers to use bank accounts. ePaynews [2006a].

81 The four parties are the consumer, the merchant, the issuer and the acquirer.

82 When the acquirer is also the issuer, the payment platform could theoretically be bypassed, however, for platforms with highly diffuse participation and different concentrations for acquirers and issuers, such occurrences may be unlikely. Yet, in highly concentrated markets, such bypass could be common.

83 The three parties are the consumer, the merchant and the single company acquirer-issuer.

84 Payment cards have other externalities into the economy such as the promotion of consumption.

85 For instance, in some countries, the VISA and MasterCard networks are able to maintain an 85 percent market share, despite fierce competition from others. Claessens [2003].

86 This type of market is also called "two-sided market".

87 See Rochet and Tirole [2003].

88 Personal identification number.

89 The British Retailers Council "has told the OFT that the withdrawal by merchants from payment card schemes is not a credible option because, in some ways, the major card schemes have become 'essential facilities'." OFT [2005], p. 81

90 An illustration is given in Katz [2001]: "By itself, the finding that credit and charge cards issued on the American Express or Diners Club networks comprise small shares of total cards or support small shares of total cardbased transactions does not prove that these systems lack market power in the sense relevant for the analysis of no-surcharge rules. For example, if business travelers using American Express corporate cards were required to use those cards when traveling for business purposes in order to qualify for reimbursement by their employers, then this requirement might generate market power for American Express with respect to merchants, particularly merchants catering to business travellers, such as airlines, hotels, and restaurants. Visa also argues that American Express cardholder rewards programs could have similar effects for other consumers." Katz [2001], p. 51

91 Ramirez [2006].

92 Banco de México.

93 Although in 2004, there were over 45 million payment cards in Mexico, only 5.6% of the individuals surveyed in the Mexican Family Life Survey (2004) had access to credit cards. Negrín [2005].

94 Negrín [2005].

95 Consumers International [2006].

96 FIEL [1998].

97 OECD [2004c].

98 Gerens [2003].

99 Euromonitor International [2006a].

100 Visa, MasterCard, Magna, Diners Club, American Express and Redcompra. Gerens [2003].

101 Gerens [2003] argue that this fee interval 1% - 4,5% cannot be justified by a difference in volume.

102 Gerens [2003].

103 Nevertheless, analysing recent acquiring contracts of several banks, the Bank of Mexico has found that they still contain a provision for the no surcharge rule.

104 American Express c/ Visa, Mastercard y Argencard

105 Euromonitor International [2006b].

106 Ramirez [2006].

107 See the case of the no-discount rule in the previous section.

108 The competition authority has also intervened in the market, for instance, it relaxed the no-surcharge rule in 1994, but these actions have been taken in an uncoordinated way.

109 Nevertheless, the interchange fee for electronic transfers was set at zero level by BM regulation.

110 Negrín [2005].

111 Weiner and Wright [2005].

112 FIEL [1998].

113 01/14/1999.

114 FIEL [2001].

115 Institute of International Bankers [2004].

116 The Superintendent of Industry and Commerce (Superintendencia de Industria y Comercio).

117 Euromonitor International [2006b].

118 See supra note 30.

119 Source: Brazilian Competition Policy System.
120 Fiscalía Nacional Económica.
121 TDLC [2005].
122 Simon [2005].
123 FIEL [2001].

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Appendix A

Permissible activities[124] for banking organizations in various financial centers in Latin America

Country	Securities[125]	Insurance[126]	Real Estate[127]	Bank Investments in Industrial Firms	Industrial Firm Investments in Banks
Argentina	Permitted	Permitted, but only with regard to pension fund affiliates	Limited; based on bank capital and investment	Limited	Permitted but subject to prior approval of authorities
Bolivia	Permitted	Permitted through subsidiaries	Not permitted	Not permitted	No legal restriction, but subject to approval of banking authorities
Brazil	Permitted through subsidiaries	Permitted through subsidiaries	Generally limited to holding bank premises	Limited to suppliers to the bank	Permitted
Chile	Permitted	Insurance brokerage permitted	Not permitted	Not permitted	Permitted up to 10% of a bank's shares, after which the Superintendent's prior approval is required
Colombia	Permitted through subsidiaries	Not permitted	Permitted through subsidiaries	Not permitted, except in connection with the resolution of debts previously contracted in good faith	Permitted
Mexico	Permitted through affiliates	Permitted through affiliates	Generally limited to holding bank premises	Not permitted	Permitted up to 20% of the shares with approval
Panama	Permitted Through subsidiaries	Not permitted	Not permitted	Permitted up to 25% of the bank's capital	Permitted

Country	Securities[125]	Insurance[126]	Real Estate[127]	Bank Investments in Industrial Firms	Industrial Firm Investments in Banks
Peru	Permitted; dealing usually conducted through subsidiaries	Not permitted	Generally limited to holding bank premises	Generally not permitted	Permitted, subject to approval of Superintendent of Banks if Investment exceeds 15% of bank's capital
Uruguay	Underwriting and brokering permitted; dealing limited to public debt; mutual funds permitted with Central Bank approval	Permitted through affiliates	Generally limited to holding bank premises	Not permitted	Permitted; subject to Central Bank approval
Venezuela	Permitted without restriction for universal banks; other types of banks limited to 20% of capital	Permitted through subsidiaries, subject to controls under the insurance laws	Limited	Limited to 20% of capital	Acquisitions of more than 10% of a bank's voting stock requires approval from the Superintendent

Source: Institute of International Bankers [2005], pp. 18-32.

124 With respect to the activities described, the chart indicates which types of financial activities are permitted. The chart is not intended to summarize the complete range of prudential restrictions which may apply to any such activities.
125 Securities activities include underwriting, dealing and brokering all kinds of securities and all aspects of the mutual fund business.
126 Insurance activities include underwriting and selling insurance as principal and as agent.
127 Real estate activities include real estate investment, development and management.