Competition and the Evolving Financial Sector Landscape

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Defining Competition

Two broad conceptions of competition:

1. Conduct of buyers and sellers
   - Rivalry exists among producers
   - ‘Level playing field’
   - Absence of a single dominant participant

2. Market structure – Pure competition
   - Atomistic buyers and sellers of a homogeneous product
# Theoretical Market Structure Types

(by type of product and number of sellers)

<table>
<thead>
<tr>
<th>Type of Product</th>
<th>Number of Sellers</th>
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<tbody>
<tr>
<td></td>
<td>One</td>
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<tr>
<td>Homogeneous</td>
<td>Pure monopoly</td>
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<tr>
<td>Differentiated</td>
<td>Pure monopoly</td>
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Implications of Market Structure

- Pure monopolists, oligopolists, and monopolistic competitors share a common characteristic: All three types of firms possess some degree of market power.
- Pure competition – the only basic structural type under which sellers possess no market power.
- => competition increases when the product becomes less differentiated, when the number of competitors increases, or when there is increased market power on the demand side of the market.
Market Structure Types in Practice

- Pure monopolists have always been rare, if they ever existed at all.
- Pure competition is rare as well.
- Suggests that most firms would seem to belong in the monopolistic competition and oligopoly categories.
  - Firms are interdependent, and they are conscious of it; *i.e.*, each firm recognises that its optimal choice depends upon the choices its rivals make.
  - Customers will have different degrees of loyalty to the firms from which they make their purchases.
Financial services regulation prior to the 1980s

Multiple goals:

- Ensure systemic stability
- Limit risk taking
- Support industrial and regional policies
- Support social policy, especially for housing
- Facilitate government finance
- Limit competition

Limited foreign influence
Widespread government guarantees
Disparities of regulatory practice
The financial sector landscape prior to the 1980s

- Segmentation by product determined by national rules
  - Banking
  - Insurance
  - Securities markets
- Geographic limits on operations
- Strict regulation of activities
  - Restrictions on pricing
  - Credit allocation guidelines
  - Limits on product innovation
- Entry barriers
  - Government ownership
  - Limits on business mix
  - Limits on portfolio holdings
  - Limits on foreign establishment and discriminatory treatment of foreign institutions
1980s & 1990s: Regulatory reform

- Barriers between different segments of financial services relaxed or removed
- Easing in restrictions on the range of products and permissible activities
- Policies adopted to preserve or enhance international competitiveness of the financial system
- Increased reliance on market forces
- Fewer structural rigidities
- Liberalisation of foreign entry
1980s and 1990s: Technology, International Linkages, Ageing Populations

- **Technology**
  - Increased the feasible scale of certain products and services
  - Lower infrastructure costs also facilitate increased distribution capacity
  - Enhanced the production and availability of information leading to more efficient risk management and more focused marketing techniques
  - Contributed to innovations in financial products and processes
    - Derivatives and other off-balance sheet activities
    - Securitisation

- **Ageing populations and demand for retirement products**

- **Globalised trading and portfolio investment**
Effects of external factors

Backdrop: ageing populations and their need to accumulate savings for retirement, the associated expansion in private pension plans and other types of institutional investors (e.g. CIS), advances in technology, internationalisation of corporate business, expanding role of capital markets and regulatory reform.

Effect: increased competition in most business segments of financial services, regardless of size or location.

Result: Efforts to reduce costs, find new sources of revenues, and employ resources more effectively.
Response of financial service providers to the changed environment

- Varies across institutions and across borders
- Alternatives are stretched across numerous dimensions:
  - Organisational structures of institutions
  - Types and combinations of activities in which they engage
  - Methods used to deliver the products & services to clients
- Includes increases in co-operative agreements and in mergers & acquisitions within service sectors (especially inside national borders)
- Includes increased convergence across types of financial service providers
  - Cross-investment (subsidiaries)
  - Alliances and joint ventures
  - Cross-production (subject to restrictions)
  - Cross-distribution (e.g. cross-selling)
  - Cross-sector risk transfers
  - Provision of integrated services (one-stop shops)
Trends in the provision of financial services

1. Some institutions confine their activities to narrow areas and compete as specialists (although none are confined wholly to a particular market segment.

2. Some institutions endeavour to offer a more comprehensive range of products, but none enjoy complete control over the market segments in which they are active.

3. All institutions rely increasingly on financial markets for funding, investments and the management of their risks.

4. Less compartmentalisation: institutions of various types now offer products and services that compete not only with those offered by similar types of institutions but also with products typically associated with institutions in other financial service sectors.
Factors affecting the evolution of the financial services landscape

1. Economies of scale exist in some areas of financial services and unit costs decline with increases in size, but not everywhere and not without limit.

2. For practitioners, the existence of profitable cross-selling potential (revenue economies of scope) has broad intuitive appeal:
   - Some studies find little or no revenue scope efficiencies and some scope diseconomies.
   - Some studies find benefits when earnings in general are increasing, but not during downturns.
   - Some firms are more efficient at joint production; others are more efficient when they specialise.

3. Potential problems concerning conflicts of interest.

4. These results suggest there may be limits to the benefits to be had from further convergence.