
Preliminary Consultation on Terms of Reference of Competition Authority Banking Study

Friday, 13 September 2002

1 INTRODUCTION

The Competition Authority proposes to carry out, under Section 30(1)(a) of the Competition Act 2002 ('the Act'), a study of competition in the provision of banking services in the State. The Act provides that it shall be the function of the Authority 'to study and analyse any practice or method of competition affecting the supply of goods or the provision of services or any other matter relating to competition (which may consist of, or include, a study or analysis of any development outside the State)'.

The Authority's decision to undertake a study of the banking sector was informed by the following four criteria:

- The economic importance of the sector;
- Indicators of the level of competition in the sector;
- The existence of public or private barriers to entry to the sector; and
- The extent of public interest in the sector.

The application of these criteria to the banking sector suggests that it merits closer examination. Banking accounts for over 4% of GNP, and banking services touch all sectors of the economy. Many markets for consumer and business banking services are highly concentrated, and the sector is heavily regulated. In addition, recent examinations by the Director of Consumer Affairs and the Strategic Banking Review (jointly by the Department of Finance and the Central Bank) highlighted potential competition issues. The Authority is also informed by complaints it receives from the public generally in relation to the banking sector.

This preliminary consultation document outlines, and seeks feedback on, the Authority's intended approach to a study of the Irish banking sector. Following this initial consultation,

the Authority will publish final terms of reference for the study and will then invite submissions from interested parties on the substantive issues.

The Competition Authority will have regard for existing work and studies in the area so as to avoid unnecessary duplication.

The final output of the study is intended to comprise a published report and a series of recommendations to be taken into account by the Government, regulatory authorities and industry participants, in order to provide for a future situation where the operation of the banking sector will accord with competition policy to the benefit of consumers.

2 PROPOSED SCOPE OF THE STUDY

It is intended that the scope of the study be wide enough potentially to include any of the markets in which the clearing banks operate. However, the Authority is mindful of the need to keep the study focussed, coherent and manageable and intends therefore to exclude the investment banking from the scope of the study.

The study will examine market structure in the banking sector (excluding investment banking) and identify relevant sub-markets. These markets will be analysed both from the perspective of barriers to entry and the degree of rivalry.

Barriers to entry may be described under three headings: private, public and exogenous barriers to entry.

- Private barriers to entry arise from the behaviour of firms in the industry. For example, the conditions of access to the clearing system or hindrances to consumer switching may discourage entry, directly or indirectly, to the banking sector.
- Public barriers to entry arise from the actions of the Government or regulatory bodies. For example, for prudential reasons, banks and other credit intermediaries must obtain the appropriate license before they can offer their services in the market place. While all barriers to entry inhibit competition, certain public barriers, such as those related to prudential concerns, are erected to protect the public interest. In this case, the Authority's approach will be to assess the

proportionality of relevant provisions. That is, the Authority will seek to determine whether public interest objectives can be served in a manner that is less restrictive of competition.

- Exogenous barriers to entry arise from non-public factors outside the control of the industry and are generally attributable to the characteristics of the market in question. Among other things, high sunk costs of entry, network and economies of scale may all influence a firm's decision to enter a market. For example, the need to have an extensive branch and/or ATM network may inhibit entry to the banking sector.

Entry, or the credible threat of entry, is a critical component of the process that ensures that markets work well for consumers. For example, the entry of Bank of Scotland to the Irish mortgage market was reported to have had the effect of lowering interest rates immediately.¹ If entry can occur with relative ease, incumbents must compete aggressively to maintain market share, have a strong incentive to minimise costs and also to pass on those cost savings to customers.

- The study will identify the barriers to entry into non-investment banking in the State, analyse their origin and, where appropriate, make recommendations to have disproportionate barriers to entry removed.

The degree of *rivalry* between firms in an industry determines the state of competition and it is influenced not only by the behaviour of firms, i.e. whether they pursue aggressive market share building strategies, but also by the behaviour of consumers. For example, if consumers are unwilling to react (consumer inertia) to price reductions then firms have little incentive to pursue that strategy since no additional market share will be earned.

There are a number of reasons why consumers may be unwilling to switch. For instance, there may be additional costs in terms of effort and inconvenience associated with switching. Switching costs can be attributed to either the behaviour or practice of firms or to legislative or regulatory provision. In the case of the former, firms have an incentive to maintain and increase the level of switching costs since to do so dampens the degree of rivalry in the

market. With regard to the latter, the effect is generally unintentional. For example legislation designed to guard against money laundering may inhibit the ability or willingness of customers to switch banks.

Another reason why consumers may be unwilling to switch concerns the degree of transparency in the market. Often financial products are complex and multi-dimensional and defy direct or simple comparison. The implication is that consumers may not be able to easily determine the relative value of a firm's product and switch as appropriate.

The pace of innovation in an industry is also an indicator of the degree of rivalry. If the rate of diffusion of new services within the Irish banking sector is less rapid than in other jurisdictions, then this may be attributable to weak competition in the sector. Certain factors of a regulatory nature may also inhibit rivalry in the sector.

- The study will identify and analyse (and where appropriate make recommendations for change to) industry practices, legislation and/or administrative practices in non-investment banking in the State that limit the degree of rivalry on the market place to the detriment of consumers.

The aims of the study are to:

- Advise the Government concerning the implication for competition of existing primary and secondary legislation and, where appropriate, to identify and make recommendations for change to legislative restrictions on competition that are disproportionate.
- Make recommendation for change to any enactment or administrative practice that is limiting competition in the State to the detriment of consumers.
- Identify issues relating to consumer inertia, information problems etc. and make recommendations to ensure that consumers can exercise their full rights so as to best advantage themselves using the competitive process.

¹ Irish Times, 22nd February 2002 and the Irish Independent, 26th March 2002.

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- To bring to the attention of the Cartel and/or Monopoly Divisions of the Authority any practice or arrangement that appears to be in breach of the Competition Act, 2002.

3 THE PRELIMINARY CONSULTATION

At this stage, the Authority invites the views of interested parties on the intended approach to the study. Later, when the final terms of reference of the study have been published, there will be a full opportunity for substantive input. For this reason, it will greatly assist the Authority if responses could be focused on the precise questions listed below. Respondents are asked to give supporting arguments and information where possible and not simply to answer “yes” or “no”.

While responses are invited from all parties the Authority is particularly interested in hearing from:

- Users of banking services, i.e. consumers and business;
- Groups that represent consumer interests or business users generally;
- Academics or other experts who have undertaken relevant research;
- Bodies representing industry, workers, social partners, and other economic groups; and
- Individuals who, in living or working abroad, have been exposed to and have useful information about banking models operated in other countries.

Submissions are invited on the following questions:

Question 1: *Do you think that the range of markets in which the clearing banks operate (e.g. loans, savings, current accounts, money transmission, etc.) is wide enough to include all retail banking markets where there are potentially competition problems?*

Question 2: *Do you think that analysing the state of competition in a market from the perspective of barriers to entry and the degree of rivalry is the appropriate approach?*

Question 3: *When examining barriers to entry, do you think that the Public-Private-Exogenous taxonomy is useful? Do you think that this approach fails to cover any barrier or class of barriers to entry?*

Question 4: *Do you think that the proposed approach toward the analysis of rivalry in banking markets is appropriate?*

Question 5: *Apart from switching costs and information difficulties, what other factors might explain consumer inertia? Please provide details, indicating in particular whether the source of the inertia is banks' behaviour, some legislative provision or otherwise.*

Please indicate if you would like to be added to an email list of contacts for this study. Persons on this list will be notified of any subsequent developments in the study, requests for submissions and changes to the web site. Naturally, advertisements will still appear in the national press, so absence from this list should be no impediment to further involvement with the study.

4 RESPONSES

Responses to this initial consultation are invited by Friday 4th October 2002.

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By regular mail to: Mr John Evans
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The web site - www.tca.ie will be the primary information source for the duration of the study.