

FINANCIAL SERVICES COMMISSION

Fair Trading Commission 2006 Shirley Playfair Lecture
Balancing the Interests of Special Interest Groups and the Public

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Commentary from the Financial Services Commission

INTRODUCTION

Ladies and gentlemen, good evening. I am honoured to have been invited by the Fair Trading Commission (“FTC”) to participate in the 2006 Shirley Playfair Lecture. This is the seventh installment and its continued popularity is a testament to the life and work of the late Shirley Playfair, in whose honour the lectures were established.

The 2006 lecture seeks to focus on how competition law and policy can strike the right balance between the concerns of special interest groups, on the one hand, and the interests of the public, on the other. As part of the invitation to participate in this event, the FTC kindly provided an extract of section 3 of the Fair Competition Act (“FCA”) which dealt how the FCA was to be applied. I was particularly struck by section 3(g) which speaks to the non-application of the provisions of the FCA to “*activities of professional associations designed to enforce*

professional standards of competence reasonably necessary for the protection of the public.”

While section 3(g) may not have been drafted with the specific interests of financial sector regulators in mind, the laws, institutions and practices that make up any modern country's financial regulatory regime (and Jamaica's is no exception) can be regarded as representing the fullest expression of standards that are “*reasonably necessary for the protection of the public*”. It is therefore opportune to consider the issue of the appropriate framework for the interplay of competition law and financial sector regulation, within the broader context of the issues being discussed today. In particular, I wish to focus on two questions that have some bearing on the debate surrounding the appropriate application of competition policy in regulated sectors. First, what is the appropriate legal and institutional structure for the application of competition policy within the Jamaican financial sector? Second, and more fundamentally, what is the appropriate concept of “competition” that should guide the conduct of competition policy in the financial sector?

THE INSTITUTIONAL STRUCTURE FOR COMPETITION POLICY IN THE FINANCIAL SECTOR

The *Report on the 4th International Competition Network (ICN) Annual Conference*, which was held in Bonn in June 2005, notes that “there is a growing consciousness of the fact that there is a role for competition in regulated sectors; and rules must be put in place to allow for that interface” (p. 4). However, how this interplay was allowed to work itself out differed across countries but it was noted that tension between competition and regulation was common to many jurisdictions, especially as it relates to the banking sector (and by, extension, the

financial sector in general). The basic *raison d'être* for economic regulation is the correction of market failures. In the case of public utilities, the case for economic regulation is premised on the existence of market failure arising from economies of scale and scope in production that result in higher unit costs if more than one firm competes in the market – thus, the existence of natural monopolies and the need to counter their market power. Market failure may also be the outcome of information asymmetries among market participants and this source of market failure is a basic reason for the regulation of financial markets. However, if information asymmetries were the only economic rationale for financial regulation, there would be little to justify the prudential regulation practiced worldwide in banking, insurance and securities markets. Market conduct regulation focusing on transparency, disclosure and governance would be sufficient to impose market discipline on the activities of financial entities.

The case for financial regulation goes beyond the correction of information asymmetries. Financial regulation, in particular prudential regulation, reflects the importance of the financial system to the wider economy and the far-reaching consequences of any significant or prolonged malfunctioning.

Financial system failure can result in substantial economic costs (interruption of business transactions, suspension of lending activity, erosion of wealth through a collapse of asset prices, dramatic slowdown in economic growth and attendant increases in unemployment, poverty and social dislocation). In the case of an incipient financial crisis, governments can intervene to minimize these disruptions, but the economic cost of financial sector rehabilitation may be the just as high, being reflected in slower growth, higher inflation, higher interest rates, higher fiscal deficits and the attendant need for higher taxes.

The enduring marriage of finance and production is also the main reason why the issue of financial sector competition may be so important for competition agencies. The essential role of bank credit and other financial services as inputs in the production of virtually all other goods and services places financial firms in an influential position whereby any allocative inefficiency or other market distortions in financial service provision are almost certain to be felt throughout the economy. However, competition and prudential objectives may not always coincide. For example, mergers and acquisitions that result in larger market shares, a stronger capital base and possible economies of scale might be viewed positively by a prudential regulator but negatively by a competition agency concerned about anti-trust issues.

A related, recent practical example of the flexibility required by a financial regulator is seen in the response of the FSC to the collapse of Dyoll Insurance Company in 2005. As soon as it became evident to the FSC that Dyoll's capital impairment arising from losses associated with Hurricane-related claims would not be resolved by an injection of new capital, the insurance company was placed under temporary management and its unimpaired book of business sold to another local insurance company with the requisite financial soundness. Time was of the essence to prevent further deterioration in the insurance portfolio and the transfer of business occurred in the space of a few days. Would an agency primarily concerned with the effect of an increase in the market power of an entity be willing or able to sanction such a deal? Would it have been better, from a competition standpoint to break up the transferred portfolio into smaller pieces and sell the smaller portfolios to a larger number of companies? What would this latter strategy involve in terms of time and the cost of numerous separate

due diligence studies? Would the outcome of this latter strategy produce a stronger financial sector, given that potential buyers would be at varying levels of financial strength?

These types of concerns are among the reasons why the FSC takes the view that, in the case of regulated financial sector companies, financial regulatory provisions should assume primacy over competition laws. This view has been shared, on an informal basis through other fora, with the FTC. Needless to say, the FTC staff have been less than enthusiastic in embracing our perspective, arguing, among other things that:

- (1) The FCA applies to situations where there is an intended or likely lessening of competition or the abuse of a dominant position but there are “public interest” provisions within the FCA which would allow the FTC the flexibility to authorize agreements or practices that may be prohibited under the Act, provided certain conditions are satisfied (for example, the FCA has provisions for the relevant Minister to exempt an activity or company from the FCA – see Section 3(h) of the FCA);
- (2) The FSC would have an opportunity to air its views in an appropriate forum before the FTC makes a decision.

The FTC staff appear to agree that there may be possibilities for the FSC and the FTC to be in conflict in competition matters relating to financial sector entities but argues that if and when such conflicts arise, they should be referred to policymakers for resolution. The FTC solution would see both the FSC and the FTC present their respective perspectives to policymakers who would resolve the issue at a Cabinet level or some other forum to be decided.

Time does not permit a full exposition of either the FSC or the FTC points of view but the brief description above does give a flavour of the various positions. Clearly, the issue of the appropriate structure for guiding the interplay of competition and regulation in the financial sector is still up for debate.

THE APPROPRIATE CONCEPT OF COMPETITION FOR THE FINANCIAL SECTOR

Traditionally, competition law and policy has been guided by a theoretical benchmark based on the efficiency and welfare gains of atomistic competition: more firms, other things being equal, are better than fewer firms, etc. However, it is far from clear that a paradigm of atomistic competition is adequate as a policy guide for efficient financial sector activity. In the financial sector, it may be the case that there are simply too few firms to rely on sheer numbers as a guarantee of vigorous competition, as is the case with the Jamaica Stock Exchange, for example, or the case with providers of specialized financial products. It may also be that there can be such a thing as "too much competition" in financial services, with large numbers of small entities surviving at the margin – some aspects of the retail securities market in Jamaica may bear some resemblance to this situation. It has also been suggested, in the context of North American markets, that substantially non-competitive pricing has sometimes been deduced in banking products, such as credit cards, with thousands of suppliers. Conversely, it is possible for competitive pricing to be observed in markets containing only one or two banks.

Perhaps what is needed for competition law and policy in the financial sector is not a concept of **competitive** markets, per se, but rather a concept of **contestable**

markets. Briefly, in contestable markets, two firms can be enough to guarantee “optimality”. The main requirement for optimal contestable markets is that entry is “free” and exit is “costless”, that is, there are no sunk or irrecoverable costs and there is a perennial threat of “hit-and-run” entry. The “hit-and-run” idea embodies the situation where, if a profit opportunity exists, a potential entrant can go in and collect gains before prices change and, if the climate becomes unprofitable, the new entrant can just depart since exit is costless. In contestable markets, firms need not be small or numerous or independent in their decision making. What is required is that there is no discrimination against new entrants in favour of incumbents. When entry and exit are completely free and efficient, incumbent monopolists and oligopolists can only prevent additional entry by offering consumers the benefits that competition brings; any deviation from this “quasi-competitive” behaviour would make them vulnerable to “hit-and-run” entry. Thus, competitive outcomes are replicated in ostensibly non-competitive markets.

How is this relevant for the conduct of competition policy in financial markets? First, it should be noted that entry into Jamaica’s financial markets is not strictly costless: there are licensing or registration requirements that must be met and, in the case of corporate entities in banking, insurance, and securities, there are minimum capital requirements. However, it is debatable whether these requirements are overly restrictive for *bona fide* entrants; the capital requirements may be a barrier for potentially small operations but in the current globalized financial markets with virtual freedom of movement of international capital, these prudential entry requirements would effectively pose little barrier to entry.

Apart from licensing or registration fees, there is very little sunk cost to financial market entry and exit. If financial markets are approximately contestable, the need for rigorous competition oversight is reduced. Market abuse can be effectively governed through appropriate rules for disclosure and corporate governance and through effective market surveillance infrastructure. In this context, oversight for competition can be easily incorporated within existing financial sector regulation and supervisory practices. It may be argued that “disorderly” exit may be costly as in the case of a crisis but this can be remedied through the design of appropriate financial safety nets (such as deposit insurance and investor compensation schemes) or a revamping of bankruptcy laws. The heretical suggestion being made here is that, with enough thought, existing financial regulation, supervisory practices and infrastructure can be made compatible with effective oversight of competition within the sector and would obviate the need for oversight by a separate agency under a separate law. Is this a better way to proceed in order to ensure the congruence of regulatory and competition considerations within the financial sector? I do not profess to know the answer but I think the issue is worth debating.

Thank you.

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