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Global Forum on Competition

THE ROLE OF MARKET STUDIES AS A TOOL TO PROMOTE COMPETITION

Contribution from Malta

-- Session II --

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This contribution is submitted by Malta under Session II of the Global Forum on Competition to be held on 1-2 December 2016.

More documentation related to this discussion can be found at www.oecd.org/competition/globalforum/the-role-of-market-studies-as-a-tool-to-promote-competition.htm

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SECTOR INQUIRY – THE MALTESE EXPERIENCE

-- Malta --

1. The Legal Basis to conduct Sector Inquiries under Maltese Competition Law

1. The Office for Competition (OC) is legally empowered to carry out sector inquiries in terms of Article 11A of the Competition Act, Chapter 379 of the Laws of Malta. Specifically, where the trend of trade, the rigidity of the prices or other circumstances suggest that competition may be restricted or distorted within the Maltese market, the Director General of the OC may conduct an inquiry into a particular sector of the economy or into particular types of agreements across various sectors. In the course of that inquiry, the Director General may request the undertakings or association of undertakings concerned to supply the information necessary for the application of Articles 5 and 9 of the Competition Act and Articles 101 and 102 of the Treaty on the Functioning of the European Union and he is also legally empowered to carry out any inspections necessary for that purpose[1]. Pursuant to the inquiry, the Director General may publish a preliminary report on the results of the inquiry into particular sectors of the economy or particular types of agreements across various sectors and invite comments from interested parties before publishing the final report[2].

2. Sector Inquiry on interest rates charged on loans to small and medium sized enterprises in Malta

2. In 2014, the Director General of the OC initiated a sector inquiry in terms of the relevant legal provisions on bank loan interest rates to Small and Medium-sized Enterprises (SMEs) in Malta following concerns raised, *inter alia*, by national and international institutional bodies on alleged high lending interest rates by commercial domestic banks to SMEs. The final report on the inquiry was issued on 10 July 2015.

2.1 The Aim and Focus of the Inquiry

3. The aim of the sector inquiry was to:

- Assess the degree of competition in the market for bank loans to SMEs;
- Identify competition concerns relating to interest rates charged by commercial banks on loans to SMEs; and
- Propose recommendations to enhance competition in the market.

4. The inquiry involved a detailed exercise which analysed the extent to which the sector reflects the characteristics of a well-functioning market, that should primarily include: (i) relatively low barriers for new players to enter the market or for existing players to expand their market share; (ii) competition between lenders to SMEs such that the market operates efficiently; and (iii) SMEs that are able to make informed decisions. Against this background, the report focused on the degree of concentration within the

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1 Article 11A (1)- Cap 379 of the Laws of Malta

2 Article 11A(4)- Cap 379 of the Laws of Malta

market, the extent of competition on the market (including barriers to entry and expansion), interest rate developments, the possibility of SMEs to switch from one bank to another, transparency on the market and the possibility for SMEs to take an informed decision when selecting their preferred bank.

2.2 Process and Method of the Sector Inquiry

5. For the purpose of data collection, the OC consulted relevant and interested parties, including Malta's core domestic banks, a number of non-core domestic and international banks, GRTU Malta Chamber of SMEs (GRTU) and the Malta Chamber of Commerce, Enterprise and Industry; supervisory and regulatory institutions (including the Central Bank of Malta [CBM] and the Malta Financial Services Authority [MFSA]) and entities which, in one way or another are related to developments in the market for bank loans to SMEs. In addition, on 16 April 2014, the OC launched a public consultation document to invite all interested parties to submit their views, feedback and evidence related to the inquiry. The consultation period closed on 16 May 2014. The information and data used in the analysis has been obtained from publicly available sources (such as banks' annual reports and the statistical warehouse of the European Central Bank), meetings held with core and non-core domestic banks, and requests for information sent to these market players as well as other entities including MFSA and CBM. The OC concluded the final round of meetings with the various market players and relevant institutions in March 2015. The OC consulted various studies carried out by other entities such as GRTU, CBM and other national competition authorities. The sector inquiry covered the period from 2007 to 2013. When sufficient information was available for the OC to conduct its inquiry, the year 2014 was also included.

2.3 Findings and Conclusions of the Sector Inquiry

6. The report made a number of observations about the characteristics of the market and the behaviour of all market players on the basis of which a number of conclusions were drawn:

- More than 99% of Maltese enterprises are SMEs[3] and the majority of these are micro enterprises that employ less than 10 workers. Since these businesses do not typically have access to capital markets, they rely heavily on bank loans to finance their investments.

- In spite of declines in concentration in the market for bank loans to SMEs, market concentration analysis, based on concentration ratios and the Herfindahl-Hirschman Index (HHI), showed that the market for bank loans to Maltese SMEs remains highly concentrated both when compared to other industries and other EU banking sectors.

- The concern about the high level of market concentration is particularly significant given the high barriers to entry and expansion that characterise the market. Amongst the more significant barriers are regulatory barriers (such as capital requirements), reputation and the need for adequate infrastructure. Other barriers to entry identified by banks included the difficulty in obtaining relevant data on SMEs and EU financial incentives for SMEs that were only accessible through a limited number of banks.

3 For the purpose of this inquiry, the definition of an SME was that adopted by the European Commission as per Recommendation 2003/361/EC of 6 May 2003 concerning the definitions of micro, small and medium-sized enterprises, that defines an SME as any entity engaged in an economic activity, irrespective of its legal form. This includes, in particular, self-employed persons and family businesses engaged in craft or other activities, and partnerships or associations regularly engaged in an economic activity. Any such entity that employs fewer than 250 individuals and which has an annual turnover not exceeding €50 million and/or an annual balance sheet that does not exceed €43 million in total is classified as an SME- (Commission Recommendation 2003/361/EC Concerning the Definition of Micro, Small and Medium Sized Enterprises [2003] OJ L124/36).

- New entrants and smaller banks have either found it difficult, or have been unwilling (for strategic purposes), to penetrate the market and expand their market shares.

- The above mentioned concerns are significant when considering that the profitability of Malta's core domestic banks, and the average interest rate on loans they charge to Non-Financial Corporations, were amongst the highest in the EU. Although there are several factors that may explain this divergence, such as the higher cost of funding (due to Maltese banks' heavy reliance on deposit funding) and credit risk (due to the relatively large share of SMEs in the banks' loan portfolio), it may also reflect differences in the profit margin. In fact, profitability indicators, such as the return on assets and equity, of Malta's core domestic banks were and had persistently been significantly higher than those of the EU average. Thus, in spite of the 2 percentage point reduction in the banks' lending rates recorded between 2007 and 2013, the OC noted that there may have been room for further reduction. In particular, it was noted that the spread between the lending rates to SMEs and the average deposit rate only started to decline following pressure by domestic and international institutions for reductions in lending rates, suggesting that banks could have lowered them earlier than they actually did.

- Interest earned by Malta's core domestic banks accounts for a significant proportion of banks' gross operating income. Despite the observed decline in the spread in 2014, the profitability of banks remained healthy and significantly higher than that of other EU banks.

- In addition to market structure, there are a number of behavioural characteristics which may have weakened competition. Primarily, among these is the lack of price transparency. Indeed, the analysis carried out by the OC showed that Maltese banks' websites provide little information to help SMEs take informed decisions when compared to that made available by international banks. The OC noted that more price transparency would enable SMEs to choose the deal which best suits their needs. Although price transparency also risks leading to price signalling between suppliers (which would in itself be considered anti-competitive), improved price transparency is desirable in a situation where suppliers are more knowledgeable than consumers. The OC believes that the banks' tools and resources make them more knowledgeable than SMEs and may therefore be able to understand what their competitors are charging even with "low" levels of price transparency. On the other hand, often, the less informed SMEs may not be able to compare the prices charged by different banks. In such cases, more price transparency may be desirable because it mainly benefits consumers.

- Competition in the SME loan market is also hindered by the reluctance of SMEs to "shop around" or switch banks. Supporting this claim were the preliminary results of a survey conducted by the Malta Chamber of SMEs (GRTU) which showed that a number of SMEs did not seek out the best deal by shopping around when taking a loan because they believe, and experience has shown them, that there is no choice in reality. Nonetheless, the survey also showed that a large number of respondents do not shop around because they prefer setting up a loan account with the bank with which they have existing accounts. Others, however, argued that they find it difficult to compare prices, conditions and services of the various banks.

- Although there are certain lock-in effects which are beneficial to the consumer, such as long-term personalised relationships between banks and SMEs, the same and other lock-in effects and costs could hinder consumer mobility. These lock-in effects include early repayment fees (charged by some banks) as well as the pressure exerted by some banks for SMEs to transfer their business current accounts with the same bank from which they want to take a loan.

2.4 Recommendations

7. On the basis of the abovementioned conclusions, the OC made a set of recommendations that aim to enhance competition in the market for bank loans to SMEs. These recommendations were addressed to banks, SMEs and the Government. Since the traditional banking model adopted by Malta's core domestic banks has worked well in terms of ensuring stability in the domestic financial sector, the OC deemed it necessary to address the above identified concerns by proposing behavioural remedies. It considered that these recommendations can be put into practice without any adverse effects on financial stability. The OC's recommendations sought to address issues primarily related to price transparency, barriers to expansion and consumer mobility such that the market for SME bank loans is conducive to competitive interest rates. Thus, the OC put forward the following recommendations:

- It was observed that banks levy charges on the issue of sanction letters, which are the proper and final valuation of fees and rates, as well as the actual setting down of the terms of the loan. These charges are considerable, and could act as a deterrent for SMEs in obtaining multiple quotations. It is desirable that SMEs consult multiple banks when considering a business loan, obtaining information about the amount of the loan, interest rates and all related charges, and the general terms and conditions of the loan. The OC recommended that SMEs have access to this information prior to incurring costs when issuing a sanction letter. Banks would issue free-of-charge quotations which include the amount of the loan, interest rates and all applicable fees, including the general terms of service. When issuing such quotations, banks could indicate those parts of the document where the conditions could vary, such as changes to the financial status of the customer. However, variation between the quoted price and the actual price should be limited to a narrow degree, so as to provide the SME with the opportunity to make a proper informed choice without incurring any cost.

- Banks should make available a list of all charges related to SME loans on their websites. This should be easily accessible and regularly updated.

- Banks should make available more information on business loans for SMEs. Examples include making available a Frequently Asked Questions (FAQs) section on business loans, providing an example of a typical SME loan and the costs involved, and make available an SME loan calculator for loans which do not exceed a certain threshold.

- Banks should also provide information regarding business loans in the Maltese language.

- Banks should not communicate more information than is strictly necessary, particularly regarding future pricing or commercial strategic plans.

- Subsequent to the provision of more information and increased price transparency, SMEs should take the initiative (and be encouraged) to shop around. The OC considered that by reducing consumer inertia, competition and entry into the market for loans to SMEs would consequently increase. In fact, the difficulty encountered by SMEs when comparing prices, conditions and services of the various banks would more likely cause consumer inertia. SMEs perception that banks would offer similar prices together with the various costs charged and lock-in effects increase consumer inertia. The OC was of the view that consumer inertia may be reduced by applying the recommendations proposed in the Report. In view of this, the OC suggested that it would be ideal if SMEs shop around more.

- Government ought to ensure the setting up of a credit register to facilitate access to credit information on SMEs. As outlined in the inquiry, banks demonstrated a certain degree of reluctance when it comes to SME lending, due to the potentially high risk profile of SMEs and the limited information that hampers access to reliable data. As a result, the difficulty for banks to assess the creditworthiness of SMEs has been identified as a barrier to entry. In the context of this inquiry, the creation of a Central Credit Register strikes the right balance between the key players: banks and SMEs alike. On one hand a credit register would allow banks to be able to reach an informed decision regarding actual and potential SME borrowers while enhancing the banks' loan portfolios, thereby leading to a lower cost of capital. On the other hand, it would also grant SMEs wider access to credit opportunities since banks would be in a better position to assess the borrowers' creditworthiness, irrespective as to whether the concerned SME is a client of the bank or not. In view of this, the OC supported the initiative of the CBM concerning the potential creation of a Central Credit Register. To this end, the creation of a Central Credit Register would drive competition between banks, foster transparency, and facilitate split banking thereby aiding access to SME loan financing where banks would be operating on a level playing field.

- Taking into account the importance of access to finance to SMEs, it is fundamental that financing schemes supported by government or the EU be available to more than one bank. Competition on such schemes would increase the availability of choice to customers (SMEs) when obtaining a business loan.

2.5 Follow-up

8. After the final report issued by the OC in July 2015, the OC set up meetings with the core banks to inquire into any initiatives, or otherwise, taken by the relevant banks and other institutions. Following these meetings, the core banks provided the OC with a roadmap to ensure the necessary implementation of the proposed recommendations. A number of core banks have already welcomed on board some of the OC's recommendations while others will be implemented in the coming months.

9. In the last few months, agreement has been reached with two of the core banks in Malta to operate a facility to support investment by SMEs in Malta. The funds form part of the European Investment Fund for SME Initiative for Malta, from which a considerable amount of enterprises will benefit. This initiative goes in line with one of the OC's recommendations as it widened the availability of choice to SMEs when obtaining a business loan thereby increasing competition between market players from a supply perspective. Another core bank has signed the first SME financing agreement in Malta under the European Fund for Strategic Investments (EFSI), the heart of the Investment Plan for Europe. The agreement will allow the bank to provide low-cost loans to innovative SMEs in Malta over the next two years.

10. Besides this, on 29 January 2016 the Central Bank of Malta Act (Cap 204 of the Laws of Malta) was amended to empower the Central Bank of Malta to establish a Central Credit Register in Malta, and to issue directives in this regard for licensed institutions to provide information on borrowers and to regulate access to the Register. The amendments to the Act came into force on 15 February 2016. The Register started operating in April 2016.