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LATIN AMERICAN AND CARIBBEAN COMPETITION FORUM

Session III: Addressing Competition Challenges in Financial Markets

-- Contribution de Mexico --

4-5 April 2017, Managua, Nicaragua

The attached document from Mexico (COFECE) is circulated to the Latin American and Caribbean Competition Forum FOR DISCUSSION under Session III at its forthcoming meeting to be held on 4-5 April 2017 in Nicaragua.

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LATIN AMERICAN AND CARIBBEAN COMPETITION FORUM



15th Latin American and Caribbean Competition Forum
4-5 APRIL 2017, Managua, Nicaragua

Session III: Addressing Competition Challenges in Financial Markets

-- CONTRIBUTION FROM MEXICO (COFECE)* --

1. Co-operation and competing powers between COFECE and financial regulators

1. In Mexico, the protection and promotion of competition in relation to financial services is a shared responsibility. The Law on the Transparency and Regulation of Financial Services¹ (LTOSF) lays down which authorities are responsible for these tasks:

- The National Commission for the Protection and Defence of Financial Services Users (*Comisión Nacional para la Protección y Defensa de los Usuarios de Servicios Financieros*, CONDUSEF);
- The National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*, CNBV);
- The Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*, SHCP);
- The Bank of Mexico (*Banco de México*, Banxico); and
- The Federal Economic Competition Commission (*Comisión Federal de Competencia Económica*, COFECE or the Commission).

2. Pursuant to Article 4 of the LTOSF, CONDUSEF, the CNBV, the SHCP, regulated credit institutions and multi-purpose financial entities may request Banxico to assess whether or not reasonable competition exists in relation to the debit, credit and services transactions of the above entities. Banxico may assess whether competition conditions prevail in the financial sector and may request COFECE for its

* Contribution from the Federal Economic Competition Commission (COFECE).

¹ *Ley para la Transparencia y Ordenamiento de los Servicios Financieros*, as amended on 10 January 2014. Available at: <http://www.diputados.gob.mx/LeyesBiblio/pdf/LTOSF.pdf>.

opinion and to determine, among other things, whether or not effective competition prevails, and the relevant markets. On the basis of that opinion, Banxico will take the relevant regulatory measures.

3. Furthermore, CONDUSEF, the CNBV, the SHCP and Banxico may request COFECE to exercise its authority with respect to financial entities pursuant to the Federal Economic Competition Law (LFCE).² To that end, those authorities may indicate the reasons prompting their request and also suggest the penalties to be imposed in accordance with the Law.

4. Likewise, the Retirement Savings Systems Law³ empowers the National Commission for the Retirement Savings System (CONSAR) to ensure that services falling within its remit are provided efficiently and on a competitive basis. Article 25 of the LSAR. In order to do this, acting on the basis of the LFCE, CONSAR may establish the necessary mechanisms to prevent absolute or relative monopolistic practices resulting from the conduct of market participants or due to a market concentration. Such mechanisms are to be applied following an opinion from COFECE.

5. It is important to emphasise that COFECE is the economic competition authority in Mexico, save in the broadcasting and telecommunications sectors. Therefore, financial regulators do not have the legal powers to apply the LFCE.

1.1 Issues

6. In 2014, Mexico promulgated a financial reform.⁴ One of the objectives⁵ of that reform was to strengthen the dynamics of competition in the financial sector. Re-worded provisions relating to the financial sector contained coercive and corrective measures relating to commercial practices capable of restricting or limiting competition in financial markets.

7. Some of the criteria in the new rules relating to the examination of prohibited practices, such as service or product exclusivity, refusal to deal, tied sales on the part of a financial institution and discriminatory treatment between agents or towards financial service users, conflict with those adopted in the LFCE. Moreover, there is a substantial difference in the fines that can be imposed, both in terms of the actual amount and the elements to be taken into consideration for the purpose of waiving or reducing fines.

8. For those reasons, the market study conducted by COFECE, described in the following section, recommended the introduction of mechanisms for co-operation and co-ordination between authorities, in order to permit continuous monitoring by COFECE of competition conditions in the financial markets and to reinforce the competition criteria used by sector regulators.

² *Ley Federal de Competencia Económica*, published on 23 May 2014 in the Official Journal of the Federation. Available at: <https://www.cofece.mx/cofece/index.php/normateca>.

³ Article 25 of the *Ley de los Sistemas de Ahorro para el Retiro*, as amended on 10 January 2014. Available at <http://www.diputados.gob.mx/LeyesBiblio/pdf/52.pdf>.

⁴ The Financial Reform was enacted on 10 January 2014: it sought to amend the 34 Orders contained in 13 bills and to enact the Law regulating Financial Groups (*Ley para Regular las Agrupaciones Financieras*).

⁵ The Financial Reform was initiated with a view to improving the performance of the financial sector, based on four strategic pillars: (1) increasing credit through the Development Bank; (2) increasing competition in the sector; (3) extending the credit of private financial institutions; and (4) ensuring the solidity and prudence of the financial sector.

2. Financial market studies

9. The Federal Economic Competition Commission has powers to advocate regulatory frameworks which are favourable to competition and market efficiency by, for example, (i) issuing opinions on the drafting or amendment of regulations,⁶ and (ii) undertaking studies to assess competition conditions in sectors or markets and provide recommendations for improving those conditions.

10. The opinions, which have certain affinities with market studies, such as market analysis and recommendations, have been issued in various segments of the financial sector, with a view to improving competition conditions in this sector.⁷

11. Through its opinions on the financial sector, the Commission has stressed the need to reduce barriers to the entry of new providers; to guarantee access to infrastructure in the sector on reasonable and non-discriminatory terms; to strengthen price regulation criteria in the absence of effective competition; to strengthen the autonomy of sector regulators; to deter anti-competitive conduct between economic agents; to provide greater protection for financial services users and improve the transparency of those services; to facilitate user mobility (switching); to make the administration of retirement savings accounts more efficient, and to promote and increase financial awareness.

12. COFECE also has powers to carry out studies, conduct investigations and write general sector reports and make proposals for liberalisation, deregulation or modification of legislation,⁸ when it detects risks to the process of free market participation, identifies a problem of competition, or is requested to do so by other public authorities.

⁶ COFECE has the authority to issue opinions in relation to bills and preliminary drafts of secondary legislation – regulations, rules, agreements, circulars and other administrative acts of a general nature – and also regarding adjustments to the programmes and policies of the federal public administration, when these would have effects that could be contrary to competition and free market participation. These opinions are issued at the request of the Federal Executive, any of the Chambers of the Congress of the Union, at the request of a party or whenever COFECE deems it appropriate, and these opinions must be published. That power is laid down in Article 12, sections XII, XIII, XIV, XV and XVIII of the Federal Economic Competition Law (LFCE), and, in accordance with Article 18 of the LFCE, it is for the Plenary Session of COFECE to issue such opinions.

⁷ (i) Opinion on the application of competition principles and free market participation in the “Retirement Savings System”, issued on 22 November 2006; (ii) Opinion for the purpose of promoting the application of the principles of competition and free market participation in retail banking services, issued on 24 April 2007; (iii) Opinion on the “Memorandum and Draft Decree repealing the Law on the Transparency and Regulation of Financial Services”, published in the Official Journal of the Mexican Federation on 26 January 2004, enacting the Law on the Transparency and Regulation of Financial Services and amending, supplementing and repealing various provisions of the Credit Institutions Law (*Ley de Instituciones de Crédito*), the Law for the Protection and Defence of Financial Service Users (*Ley de Protección y Defensa al Usuario de los Servicios Financieros*) and the National Banking and Securities Commission Law (*Ley de la Comisión Nacional Bancaria y de Valores*), issued on 25 April 2007; (iv) Opinion on the “Preliminary Draft Resolution” amending the general provisions applicable to credit institutions, issued on 24 July 2008; (v) Opinion on the Preliminary Draft Insurance and Surety Institutions Law, and amending and supplementing various provisions of the Insurance Contracts Law, issued on 5 March 2010; (vi) Opinion on the Draft Decree enacting the Law on Insurance and Surety Institutions, and amending and supplementing various provisions of the Insurance Contracts Law, issued on 5 December 2012.

⁸ Article 12, section XXIII, of the Federal Law on Economic Competition, published on 23 May 2014 in the Official Journal of the Federation.

13. Thus, in 2013, when the Federal Executive presented the Draft Decree⁹ on financial reform, Congress instructed COFECE to investigate competition conditions in the financial system and its markets.¹⁰ In accordance with that Decree, and following the outcome of its investigations, COFECE could, if appropriate, make recommendations to the financial authorities for improving competition conditions in that system and its markets.¹¹

14. Further to that mandate, on 16 January 2014, COFECE launched its investigation with respect to various products and services of the financial system and its markets.¹²

3. Market Study: Investigation and recommendations regarding competition conditions in the financial sector and its markets

15. COFECE undertook a diagnosis of the underlying reasons for the inadequate performance of the market in terms of efficiency, competition and consumer welfare and made suggestions for improvements.

16. In order to arrive at that diagnosis, various elements were analysed, such as:

- sectoral structure and characteristics (number of providers and customers, product and service differentiation, existence of barriers to freedom of movement, degree of vertical integration, etc.);
- regulation of entry to the financial sector (for example, minimum start-up capital or credit and trading history) and of current trading (for example, prudential regulation, regulation of transparency and consumer information; regulation of the exchange of credit information); and
- conduct of economic operators active in the sector.

17. This investigation work, conducted according to best international practices,¹³ was undertaken in four main phases: an initial “pre-launch” phase in which the study team was assembled, the goods or services to be analysed were defined, the key players in the sector were identified and the scope of the analysis was determined; a second “launch” phase when the detailed work schedule was incorporated. The third “collection and analysis of information” phase consisted of collecting information from various sources and identifying and analysing the problems observed in the sector, in addition to possible remedies. In the final “conclusions and recommendations” phase, COFECE made a series of recommendations and

⁹ Decree amending, supplementing and repealing various financial provisions and enacting the Law regulating financial groups.

¹⁰ The study was carried out in accordance with the rules in force at the time Congress issued its mandate, in other words the Federal Law on Economic Competition, published in 1992, whose principle reforms took place in 2006 and 2011.

¹¹ Although COFECE has no power to intervene in markets based on the conclusions of a market study, such studies are considered a useful tool to advocate competition before regulatory authorities, the Mexican Congress and the public opinion at large. Their conclusions can also help COFECE to identify problems in markets where anti-competitive practice or conduct is suspected and may result in the launch of an *ex officio* investigation.

¹² For further information regarding the study, please consult: <https://www.cofece.mx/cofece/index.php/prensa/historico-de-noticias/trab-inv-recom-sec-fin>.

¹³ Such as market studies carried out in the United Kingdom, available at: <https://www.gov.uk/government/consultations/competition-and-markets-authority-guidance-part-2>; in Spain, available at: <http://www.cnmc.es>; and in the European Union, available at: http://ec.europa.eu/competition/publications/reports_en.html.

proposals, both to sector regulators and to government institutions, aimed at promoting competition in the financial sector.

3.1 *Choice of financial products and services*

18. Thus, as a first step towards producing a market study, the Commission made an analysis of the various products and services offered by the different economic agents comprising the Mexican financial system, paying special attention to activities which had the biggest impact on the functioning of the system and on consumer welfare.

19. Subsequently, it identified structural aspects of sectoral regulation, and also competing powers of the authorities in relation to the services analysed. This led to identification of cross-functions within the system itself and provided information about the “unbundled” nature of the various products and services on offer, thereby permitting an initial classification of activities for the purposes of the study.

20. Using that initial classification, the Commission identified various common factors which could affect the level of competition in the financial sector, based on its experience of analysing the financial system, of working meetings with experts in the field and with sectoral regulatory bodies and other public institutions and international bodies.

21. In this way, it was able to classify the financial products and services forming the subject of the study:

- Significant transversal aspects: regulatory aspects (requirements governing the constitution and operation of financial entities; prudential regulation; inherent risk; resolvability of failing financial institutions; competing powers; penalising of commercial practices); payment systems; credit information companies (SICs); trust funds and government intervention (development bank and subsidies);
- Credit: consumer (credit cards, nominative, personal, auto, other loans), housing and commercial;
- Savings: deposits in regulated entities; evaluations and investment funds;
- Market financing; and
- Insurance.

3.2 *Progressing the study and agreements with other bodies*

22. For each of the financial products and services mentioned above, the Commission analysed the characteristics of demand, the supply structure, the applicable regulation and the expected impact of the legislative amendments changes resulting from the financial reform.

23. This analysis led to identification of structural elements, regulatory elements and gaps in the market, in addition to restrictions and conduct which were capable of hindering competition for each of the financial products and services analysed.

24. In addition, there was collaboration with various entities in the federal public administration, such as the National Banking and Securities Commission, the National Commission for the Retirement Savings System, the National Commission for the Protection and Defence of Financial Services Users, the National Insurance and Surety Commission, agricultural trust funds and the Bank of Mexico.

3.3 *Elements for analysing competition*

25. The Commission adopted a set of standard tools for the analysis of industrial organisation (structure-conduct-performance) and incorporated elements which are typical of the new industrial organisation such as decision theory and games theory. The choice of methodology was tailored to the problems, data and theories characteristic of each individual case, the best practice being to regard the two approaches as complementary for the purpose of examining the financial sector.

26. In this instance, the Commission analysed, on the one hand, the structural characteristics of the sector and, on the other hand, the conduct of economic agents.

27. The Commission analysed the structural features of the various services which could limit competition:

- Economies of scale. These could constitute a barrier to market entry for new providers of various financial services who lack the size needed to achieve lower unit costs or more efficient operation.
- Hidden costs. Investment in reputation and brand visibility can be important for ensuring the viability of a financial services provider. If a provider is unable to make such an investment, he is at a disadvantage in relation to competitors.
- Economies of scope and multi-product enterprises. By combining more than one activity in a single provider, average costs are reduced. Likewise, users find it less attractive to change service provider when they are used to obtaining several services from a single provider.
- Costs associated with regulation. The provision of financial services by small-scale financial intermediaries is much more costly due to the expense of regulation; this constitutes a barrier to market entry.
- Amendment or switching costs. These occur when a consumer experiences difficulty in replacing a service provider. Such costs can give enterprises the opportunity to increase prices or practice price discrimination depending on the customer profile, without the customer being able to react by changing provider, and it reduces competition by new providers because it is complicated for them to attract customers who have established links with other institutions.
- Information asymmetry. Creates an imbalance of power in transactions which can sometimes make it difficult for customers to make a proper assessment of the costs and benefits of a particular product compared to other products available on the market, and prevents them choosing the best option in terms of price and quality. Service providers, being better informed, can make higher than normal gains by differentiating their products.
- Network economics. It is likely that enterprises with established networks have little interest in offering effective interconnection to market entrants, which could lead to the largest network becoming a monopoly. Card payment systems and the adoption of security technologies such as magnetic strips or chip and PIN are associated with network effects.
- Two-sided markets. A particular feature of the provision of payment services is the existence of two user groups that interact by means of a platform; the decisions of each group affect the other via an externality, and optimum prices depend on the elasticity of demand, the nature and intensity of indirect network effects and marginal costs, on both sides of the market.

28. In addition, in order to establish the degree of competition in the sector, the Commission analysed the conduct of market players, with a view to finding out what happens when they implement certain actions or strategies:

- Sales packaging incentives by enterprises. This practice is often prevalent in market structures where there are economies of scope which favour multi-product enterprises. In general, this has efficiency benefits for enterprises and consumers alike, but it can also be used to crowd out competitors.
- Situations where vertical or horizontal integration can crowd out competitors. This can have adverse effects, mainly where it has the aim or effect of excluding competitors in the downstream market, preventing market entry for players in the upstream market or facilitating collusion between competing operators.
- Too many points of contact between competitors can encourage co-ordinated behaviour. The fact of having multiple points of contact between players in the same sector facilitates both information exchange and co-ordination of strategies, whether explicit or implicit.
- Artificial increase in transaction and provider switching costs. This is when costs are artificially increased in order to create “captive” customers who will be unlikely to respond to offers by competitors. This means that the provider will have more scope for raising prices or reducing quality.
- Reluctance to share information in order to mitigate the problem of information asymmetry. A feature of the financial system is that it offers the customer complex or sophisticated products, in some cases offering a wide variety of products which might appear similar. Information is a very important input for the financial system, and so it is likely that providers with more information will want to maintain their position on the market and be reluctant to resolve the information asymmetry problem unilaterally, either by sharing the information with their market rivals or with their prospective customers.
- Price discrimination resulting from high switching costs and information asymmetry. The existence of high switching costs for users and the problem of information asymmetry are elements which can make it easier for a market player to sell products or services with similar characteristics at different prices.
- Incentives for market players to fragment networks. It is common for the largest enterprises to oppose openness or compatibility, given that the platforms formed by networks, of bank branches and cash machines for example, constitute a significant barrier to new competitors, whereas smaller or weaker firms tend to be helped.

3.4 Results of the market study

29. As a result of its investigation, COFECE concluded that there were considerable opportunities in terms of regulation or sector policy, and made 36 specific recommendations (see Annex), in five basic fields:

- Avoid crowding out to avoid preventing access to financial markets for competitors. With this in mind, the Commission made recommendations geared to ensuring, on the one hand, that regulation encourages market players to share their networks and infrastructure with competitors and provide access and, on the other hand, that all players in the sector can access the same information.

- Reduce risks of co-ordinated anti-competitive effects between competitors. COFECE found that, in the Mexican financial sector, there are conditions which could facilitate co-ordination between market players and have anti-competitive effects. These recommendations are aimed at preventing such behaviour in order to reduce prices and improve the quality of services.
- Reduce barriers to competition. The recommendations focus principally on improvements to the legislative framework with a view to increasing the number of market participants.
- Eliminate restrictions on the efficient functioning of markets. The recommendations under this heading seek to improve information in financial markets in order to facilitate decision-making and improve government regulation or intervention, thereby creating greater efficiency in financial markets.
- Increase the effectiveness of the investigation and punishment by the competition authority of possible infringements of the Federal Law on Economic Competition. The aim is to improve market monitoring, information and analysis so that COFECE is in a position effectively to fulfil its constitutional mandate in this sector of the economy.

30. By means of this study, COFECE offers the legislature and sector regulators some pointers towards improving the rules by which the financial system operates, for the benefit of users and the productive sector.