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Co-operation between Competition Agencies and Regulators in the Financial Sector - Note by Denmark

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More documents related to this discussion can be found at:

www.oecd.org/daf/competition/cooperation-between-competition-agencies-and-regulators-in-the-financial-sector.htm

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Denmark

1. Following the financial crisis the financial sector have witnessed a wave of regulatory reform aimed at increasing the resilience of financial institutions and thereby the economy as a whole.

2. This process was necessary and successful in increasing financial stability - and the process continues. For instance, it is expected that financial institutions will be faced with increased capital requirements in coming years. Also, in Denmark a main concern for several policy initiatives is to lower the amount of risky mortgage loans, e.g. loans with a non-fixed interest rate.

3. That being said, much financial regulation also has an impact on competition and increased co-operation between competition agencies and regulators in the financial sector would be beneficial. A recent Danish case illustrates the need for cooperation.

4. In August 2017 the Danish Competition Council published a major sectoral inquiry into the Danish mortgage market.[1] The analysis showed that even though a unique structure of the Danish market for mortgage loans ensures mortgage loans on fair terms and at low interest rates compared to other countries there are still major issues due to lack of competition. In short this means that the fees (prices) set by mortgage institutions, i.e. additional interest fees and other fees, are higher than they would have been under more competitive circumstances.[2]

5. The analysis addresses several reasons and indications for the lack of competitive pressure in the Danish mortgage market. One reason is high concentration with only four suppliers combined with considerable entry barriers.

6. Another reason is high switching costs and limited competition in the distribution of mortgage loans combined with the fact that consumers perceive mortgage loans as a very complex service.

7. In view of this the Competition Council have proposed several policy initiatives aimed at increasing competition by 1) lowering entry and expansion barriers, 2) increasing transparency from the perspective of consumers, 3) making it easier for consumers to acquire additional offers on loans and 4) making it easier to switch between suppliers. An example of such an initiative is a proposal on a short, mandatory standardized cover which would make it easier for consumers to understand, review and compare mortgage loans from two or more suppliers[3].

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[1] ”Konkurrencen på realkreditmarkedet”, august 2017, Konkurrencerådet. An English summary is under way and will be published as soon as possible at www.en.kfst.dk.

[2] Note that most Danish mortgage loans are financed by the issuing of mortgage bonds by financial institutions. For the vast majority of mortgage loans the actual interest rate is therefore not set by banks or mortgage institutions but by the demand for bonds on the mortgage bond market. In facilitating this arrangement the mortgage institution sets its own prices, i.e. additional interest rate and other fees.

[3] An experiment using biometric readings of the facial expressions of respondents was conducted by iMotions on behalf of The Danish Competition and Consumer Authority in order to analyze the potential effect of such a standardized cover. The test results showed that respondents were less

8. On top of the anti-competitive features of the market itself financial regulation has also had the side effect of indirectly impeding competition. A few examples are given below.

1. Example of financial regulation by the European Commission: The use of IRB-models

9. In 2007/2008 all Danish mortgage institutions implemented the use of IRB-models in assessing their capital requirements. This resulted in a huge drop of approx. 25-75 percent compared to previous years when capital requirements were calculated using the standard approach.

10. Using IRB-models to assess capital requirements has given a more accurate depiction of the financial risk in mortgage institutions. By itself this is hugely beneficial to suppliers (and consumers if a certain pass through exists) since it lowers the financial costs of the mortgage institutions considerably. But it also creates an entry barrier since an entrant in the Danish mortgage market would be met with a capital requirement of almost thrice the size of the smallest incumbent in the Danish market because the entrant can only use the standard approach in assessing the capital requirements. An entrant would have to develop the necessary setup and receive approval from the authorities in order to incorporate IRB-models.

2. Example of financial regulation by from the European Commission: Liquidity coverage ratio (LCR)

11. Danish mortgage bonds are issued in bond series according to their interest rate and general terms. The investors are typically other financial institutions. The demand from investors for a mortgage bond is greater when the bond is issued in a large bond series.

12. This is partly due to the fact that bonds from large bond series naturally will have a higher liquidity. But it is also due to the fact that following the CRR regulation[4] financial institutions in the EU can use bonds from large mortgage bonds series to meet their liquidity coverage requirements (LCR).

13. This gives larger mortgage institutions a competitive advantage because it will be easier for them to have several large bond series.

frustrated and found it easier to locate and compare important key figures when a standardized cover was applied to loan documents.

[4] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending regulation (EU) No 648/2012.

3. Example from financial regulation by Denmark: The Supervisory Diamond for mortgage institutions

14. In the aftermath of the Financial Crisis a supervisory diamond for Danish mortgage institutions was proposed.[5] The diamond consists of five benchmarks that limit the composition of the portfolio of loans in each institution. For instance, one benchmark is a cap of 25 percent on the share of loans with a loan-to-value of 75 percent and an interest rate fixed in less than two years.

15. Caps like this on the portfolio of a financial service provider has the potential to reduce uncertainty about competitors reactions in the market when setting prices. There are only four mortgage institutions in Denmark, and these four competitors have easy access to information on how competitors are benchmarked in the supervisory diamond and if and when the restrictions of the diamond become binding.

16. It is less risky to increase prices, i.e. by raising fees, on the regulated loans, if competitors are limited in accepting costumers that try to flee the price increase. The diamond thus reduces the (own-) price elasticities in the mortgage market. The competition effect by the diamond is aggravated by the oligopolistic nature of the Danish mortgage market.

17. Examples like these emphasize the need for increased co-operation between competition agencies and regulators in the financial sector. It seems that there are instances where financial regulation do not take direct or indirect implications on competition into consideration.

18. A natural focus of financial policy is on financial stability, but it is worthwhile to consider whether the goals in regards to financial stability could be met in ways that do not impede competition.

[5] A comparable supervisory diamond for Danish banks was introduced in 2010.