Slovenian Competition Day

Platform Entry under Asymmetric Regulation

A Case Study

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RETAIL BANKING / PERSONAL AND SME LENDING
COMPETITION IN RETAIL BANKING

- Competition in retail banking, especially in consumer and SME lending, is widely considered to be weak both in Europe and the US.

- This may be due to the existence of switching costs and other barriers to entry.

- Most importantly, incumbent banks have superior information about their customers.
  - Current account information
  - Credit history
  - Other hard information
  - Soft information: *Relationship banking*
Growing consolidation has aggravated the problem in recent years
COMPETITION IN RETAIL BANKING

- Banking regulators have typically considered increased competition risky for financial stability.

- Prudential regulation concerns prevailed and still prevail over competition policy objectives.
FINANCIAL INTERMEDIATION IS EXPENSIVE

- Thomas Philippon (2015, 2018) using US data and Bazot (2014) for Europe show that the unit cost of financial intermediation is high and has only declined marginally since the 2008 crisis.
FINANCIAL INTERMEDIATION IS EXPENSIVE

- Reductions in the unit cost of financial intermediation would increase consumer welfare: agents in the economy are willing to pay 8.7% of consumption to bring the unit cost of intermediation down to 1%
BANKS PROFITS

European Banks’ ROE, 2018
Source: EBF

European Banks’ ROE, 2007-2017
Source: EBF
BANKS PROFITS

Figure 2: Return on equity and cost of equity, European banks

Source: ECB

Sources: Bloomberg, Datastream, Consensus Economics, ECB calculations.
The Digital Opportunity
FINTECH START-UPS

- Entry by traditional players is unlikely because incumbent banks have many advantages: customer base, experience, reputation and knowledge of existing regulations

- FinTech start-ups may be able to enter successfully because they operate leaner businesses, benefit from the use of the art technologies, provide specific services, and being funded with much more equity will have a regulatory advantage

- However, they face some non-trivial disadvantages:
  - No installed customer bases – data disadvantage
  - No established reputation
  - Lack of brand recognition
  - No TBTF subsidies

- Their impact on retail (consumer) and SME banking is unclear. They will likely compete effectively offering payment solutions to large firms and advisory services in capital markets
FINTECH START-UPS

The entry of Big Tech players into online banking may increase effective competition in retail and SME banking (e.g. lending and payment markets) by leveraging their superior information about consumers preferences, habits and conduct to offer better targeted banking products and to reach out to consumers that may not be served otherwise.

Big Tech players may also be able to offer new services by bundling their existing services with traditional banking products.

They not only have lots of valuable customer data, they also have the analytical tools (e.g. AI algorithms) to analyze and interpret such data in order to anticipate their customers’ needs and influence their conduct.

And they have the scale required to profitably invest in the development of new tools.
Big Tech Platforms may act as **marketplaces**

Platforms that offer the ability to engage with different financial institutions from a single channel will become the dominant model for the delivery of financial services.

*The shift to multiple-provider platforms as a channel to distribute and trade is gradually emerging across geographies and throughout a wide range of financial products – here are just a few examples of what has been developed.*

Or as **intermediaries**, in direct competition with incumbents.

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**Big Tech Firms Are Behaving Like Big Banks**

All that remains is for regulators to treat them like it.

*By Lionel Laurent*

12 de marzo de 2018 8:00 CET
Unlike FinTech start-ups, Big Tech Platforms (a) have exceptional data and the ability to monetize it effectively, (b) play a central role in relation to many consumer decisions impacting on their financial choices, (c) enjoy significant brand recognition and customer trust.

Big Tech Platforms threaten the most profitable lines of business of incumbents:

- According to a recent McKinsey report, they could target the distribution business of banks, which represents 47% of their revenues but 65% of their profits and has an ROE of 20% (compared with an average ROE of 7-8%)
- Rakuten issues credit cards and offers financial services, e.g. mortgages and securities brokerage
- Amazon provides lending and factoring services for small and medium enterprises
The coming collision between financial institutions and large techs leads to tough choices for all firms: become dependent on large techs or risk falling behind.

**Implications for Fintechs**
- Fintechs may have opportunities to work with large techs to broaden their reach, while also helping large techs enter financial markets.
- Fintechs may be attractive targets for incumbents seeking to acquire technical talent.

**Implications for Regulators**
- How large techs are treated under traditional regulatory frameworks will have a large impact on their interactions with financial institutions.

**Implications for Incumbents**
- Incumbents will have to compete with large techs for talent, driving up the cost of technology talent.
- Incumbents risk falling far behind on technological offerings if they minimize engagement with large techs to protect independence.

**Implications for All Financial Institutions**
- All financial institutions will need to find ways to partner with large techs without losing their core value proposition.
- All firms risk becoming dependent on large techs, which necessitates the loss of some control over both costs and data.
IMPLICATIONS

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Asymmetric Regulation
What does a level playing field mean when incumbents are too-big-to-fail? Or when they rely excessively on short-term leverage? The level playing field argument applies when entrants are supposed to do the same things as incumbents, only better and/or cheaper. But if the goal is to change some structural features of the industry, then a strict application of the level-playing field principle could be a hindrance...

... one can see capital requirements as a way to reduce barriers to entry and foster a level-playing field
ASYMMETRIC REGULATION

- **Payment Systems Directive 2**
  - Banks will have to allow authorized Third Party Providers (TPPs) (i) access to their customers’ account information and (ii) make payments from customers’ accounts
  - TTPs will be able to compete with banks by offering payment initiation services (PIS) and account information services (AIS), thus threatening incumbents’ profitable distribution services

*Example: The European Union's revised Payment Services Directive (PSD2) threatens to disintermediate payment networks by mandating that banks allow open, secure connections between merchants and user accounts*

Asymmetric regulation regarding data portability

Banks are obliged to provide customer data to all authorized competitors in digital form and free of charge.

Big Tech are obliged to facilitate data portability only where it is technically feasible.

Big Tech Platforms have to observe GDPR only and will *de facto* retain economic sovereignty over the data of their customers, according to a recent EY report.
Big Tech Entry
THE BIG TECH THREAT

- Big Tech companies operate **disruptive business models**, which may allow them to **dominate consumer and SME banking** as they have monopolized other markets.

- Experience shows that when Big Tech companies enter industries with complex vertical value chains, they seek to monopolize the layer or layers where they operate, entrench those monopolies by taking advantage of network effects, and extract value from all other layers by
  
  - **Vertically integrating** upstream and/or downstream

  - **Discriminating** in favour of their own upstream/downstream businesses in their core platforms

  - **Leveraging** dominant services and/or data superiority to attack adjacent markets
VERTICAL INTEGRATION AND PREFERENCING

1. VERTICAL INTEGRATION

2. DISCRIMINATION

SERP INTEGRATION STUDY: GOOGLE SHOPPING

Trends for Google Shopping Units vs. SEO Visibility of Competitors 2013 - 2017

- +327%
- -58%
ENVELOPING STRATEGIES

Cross Subsidization

1. Dominance
2. Privacy Policy
3. Data Gathering
4. Distortion of Competition
5. Tipping

1. Dominance
2. Privacy Policy
3. Data Gathering
4. Distortion of Competition
5. Tipping
LEVERAGING ONLINE PLATFORM POWER ONTO BANKING
ENTRENCHED DATA SUPERIORITY
The power of Big Data corporations and their central place in providing services that are now essential in our everyday lives raise significant questions about the adequacy of global frameworks for competition and regulation. The ordinary consumer may in practice have no choice in whether to deal with these corporations on terms which are non-negotiable and are often too general to be well understood. And without access to the data which consumers have signed – or clicked – away, new businesses may find it very difficult to compete.
Implications for Competition and Financial Stability
IMPACT ON THE COMPETITIVE PROCESS

KEY FINDINGS | EXPERIENCE OWNERSHIP

Customers will interact with fewer and fewer distributors in the future, as the market consolidates and major firms gain market share.

**Implications for Fintechs**
- Fintechs, lacking both an existing customer base and the ability to scale quickly, will have to find niches if they wish to become distributors.
- In contrast, distributors may help fintechs compete with incumbents as manufacturers of specialized financial products.

**Implications for All Players**
- Product distribution represents a likely point of entry for large tech firms, due to their expertise.

**Implications for Regulators**
- Regulators will have to guard against product distributors abusing their market power, especially in open platforms where distributors control the customer shopping experience.
- Questions about how distributors and manufacturers share have far-reaching consequences.

**Implications for Incumbents**
- Incumbents will have advantages in the race to become distributors due to their existing customer base.
- However, incumbents that fail to become product distributors will see a decline in product profit margins due to cost commoditization.

**Implications for All Financial Institutions**
- All firms will seek to be distributors of both their products and those of others; their success will depend on the existing market and whether they can capture mindshare.
- Product distributors may struggle to achieve ubiquity and consistency of experience across an increasingly fragmented universe of connected devices.
IMPACT ON FINANCIAL STABILITY

- **Potential moral hazard** problems
  - Since platforms have little or no stake in e.g. the loans they help to originate. Vallee and Zeng (2018) explain that as the platform takes a more central role in screening loans, it has incentives to reduce the quality of the loan pool to maximize loan origination volume. This results in lower returns compared to scenarios where sophisticated investors are active in loan evaluation and funded only high-quality loans.
  - And traditional banks will have less of an incentive to engage in credit screening

- **Potential adverse selection** problems due to
  - *Cream skimming*: platforms may be able to screen out bad loans more effectively than FinTech start-ups and traditional banks
  - The *arm's length double-blind nature* of peer-to-peer lending makes online lending susceptible to adverse selection by borrowers: Balyuk and Davidenko (2018) show that default rates on P2P loans are higher than on other credits to consumers with similar credit scores

- As a result, credit risk may be shifted to traditional banks, their investors and their depositors and lending may prove less efficient
We need to anticipate the fundamental questions which Big Data, artificial intelligence and behavioural science present, and make sure that we innovate ethically to shape the answers. Society in general and policy makers in particular need to think about how to mitigate the risk that an algocracy exacerbates social exclusion and worsens access to financial services in the way that it identifies the most profitable or the most risky customers.
Policy Implications
The exchange of credit information between banks and non-financial companies may affect negatively the efficiency of credit markets when (a) borrowers can borrow from both of them and (b) banks are required to exchange information about their customers but their rivals are not.

- Adverse selection problems
- Moral hazard problems
NEGATIVE IMPACT OF ASYMMETRIC DATA REGULATION

- Reduced incentives of banks to invest in information collection and loan screening
NEUTRALITY OBLIGATIONS

- **Strong neutrality**
  - Platforms ought to employ “neutral” algorithms that determine result rankings based on some “objective” metric of relevance
  - Difficult but not impossible:
    - Computer Reservation Systems: Amadeus, Sabre

- **Weak search neutrality**
  - Platforms ought not to give preference to their own content but should instead employ “neutral” algorithms that determine result rankings based on some “objective” metric of relevance
  - WSN addresses the so-called own-content bias
  - Google Shopping case suggests remedies are not easy
And finally, trust requires good communication so that consumers understand and accept a firm’s approach to using their data. By good communication, I don’t mean pages and pages of obscure disclosures, disclaimers and consents. I mean short and readable statements which make it clear what firms will and won’t do with their customers’ data. These need to be developed with consumers, not imposed on them. A number of firms do this already but many do not. Should all businesses have a data charter? Should these be developed through voluntary codes of practice? Will the industry take the lead or should they be a regulatory requirement?
DATA SHARING?

- **Competition Policy**
  - Difficult in Europe:
    - The exceptional circumstances test:
      - Dominance
      - Indispensability
      - Elimination of all effective competition
    - Which remedies?
  - Nearly impossible in the US

- **Regulation**
  - Which info?
  - At which price, if any?
  - Privacy concerns
    - Opt-out v opt-in clauses?
  - Reciprocity?
DATA SHARING?

- Impact on incentives to screen, loan rates and interest rates
  - Depends on price at which information is shared
  - At high prices, incentives to screen are increased, loan numbers increased and interest rates fall
Concluding Remarks
AN IMPORTANT CAVEAT!!
THANK YOU!

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View my research on my SSRN author page: http://ssrn.com/author=47132