Slovenian Competition Day

Platform Entry under Asymmetric Regulation

A Case Study

27 September 2018

Jorge Padilla

CONTENTS

Case Study: Retail Banking

RETAIL BANKING / PERSONAL AND SME LENDING

COMPETITION IN RETAIL BANKING

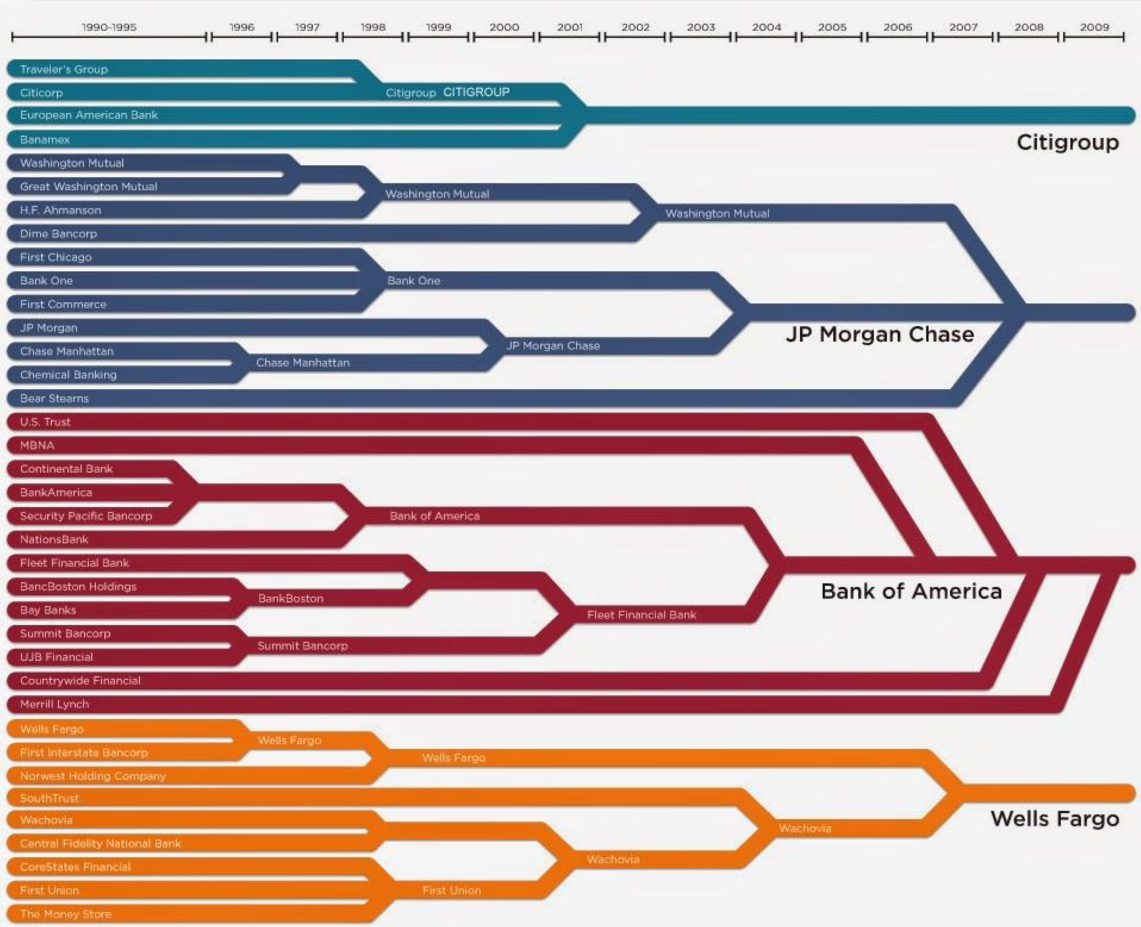
- Competition in retail banking, especially in consumer and SME lending, is widely considered to be weak both in Europe and the US

- 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*

COMPETITION IN RETAIL BANKING

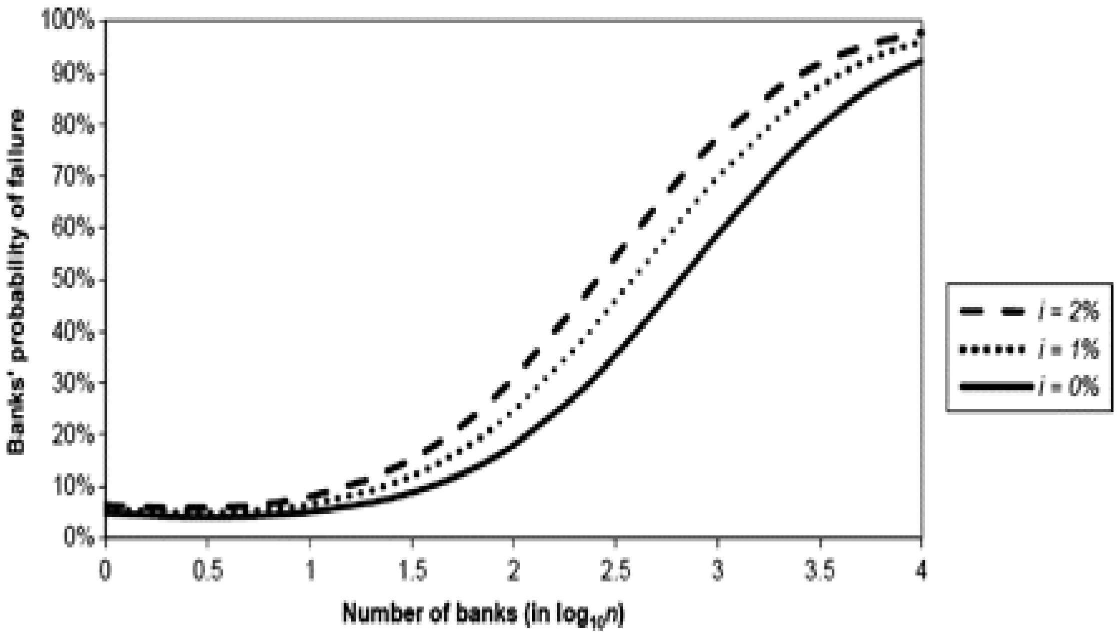
- Growing consolidation has aggravated the problem in recent years

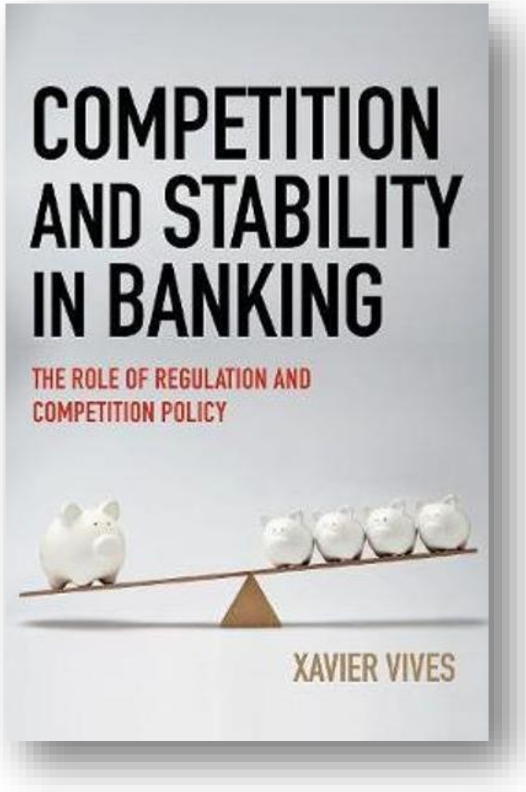


Source: Federal Rserve; GAO; The Daily Bail

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

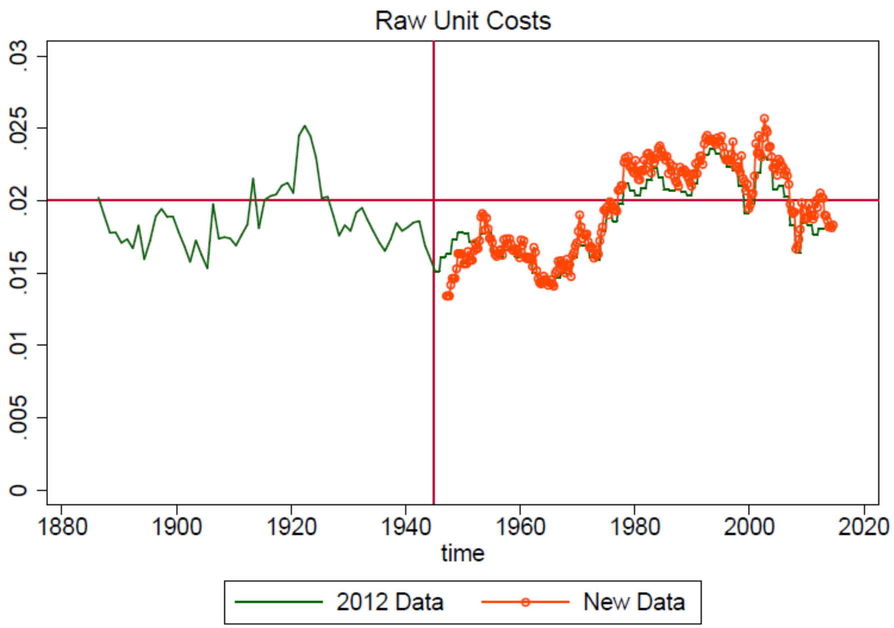




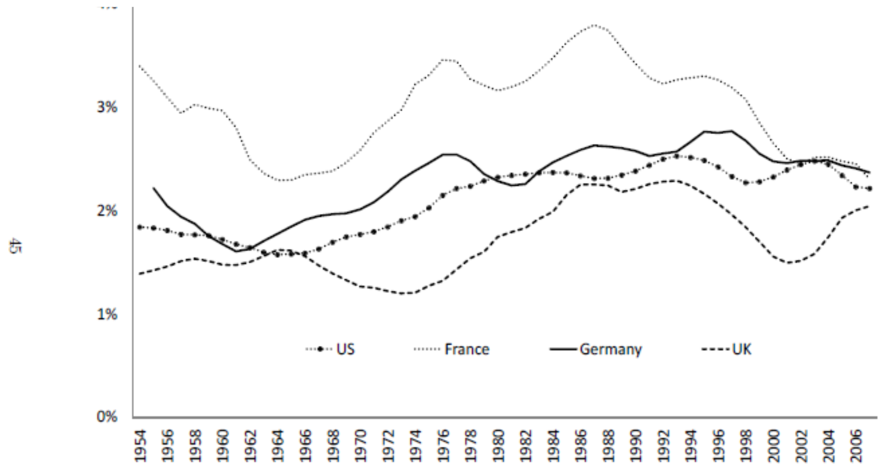
FINANCIAL INTERMEDIATION IS EXPENSIVE

- 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

US

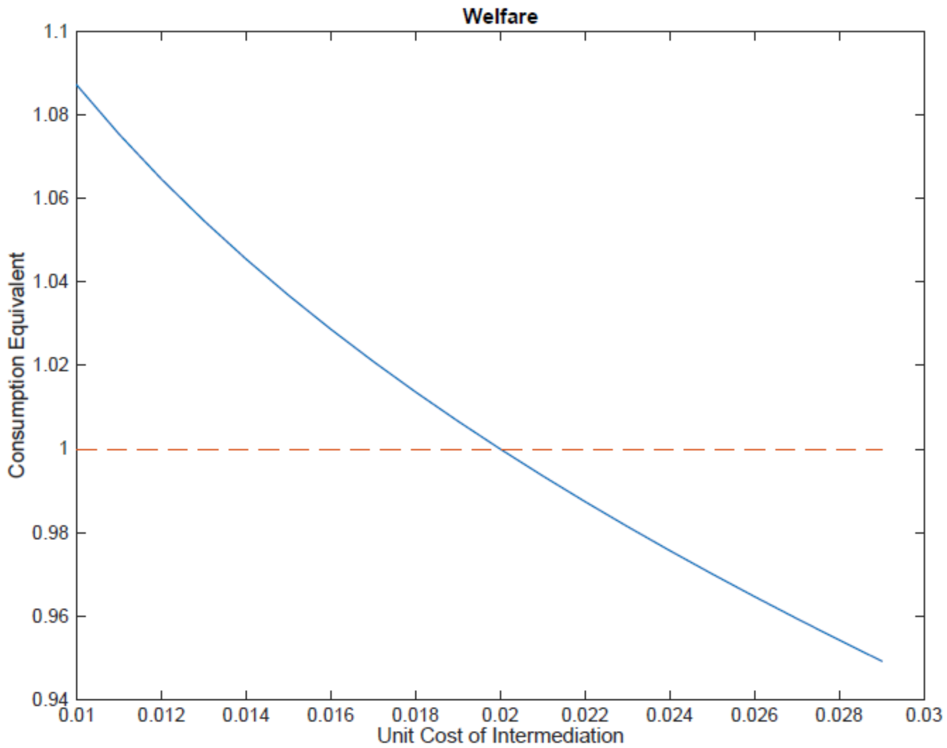


EUROPE

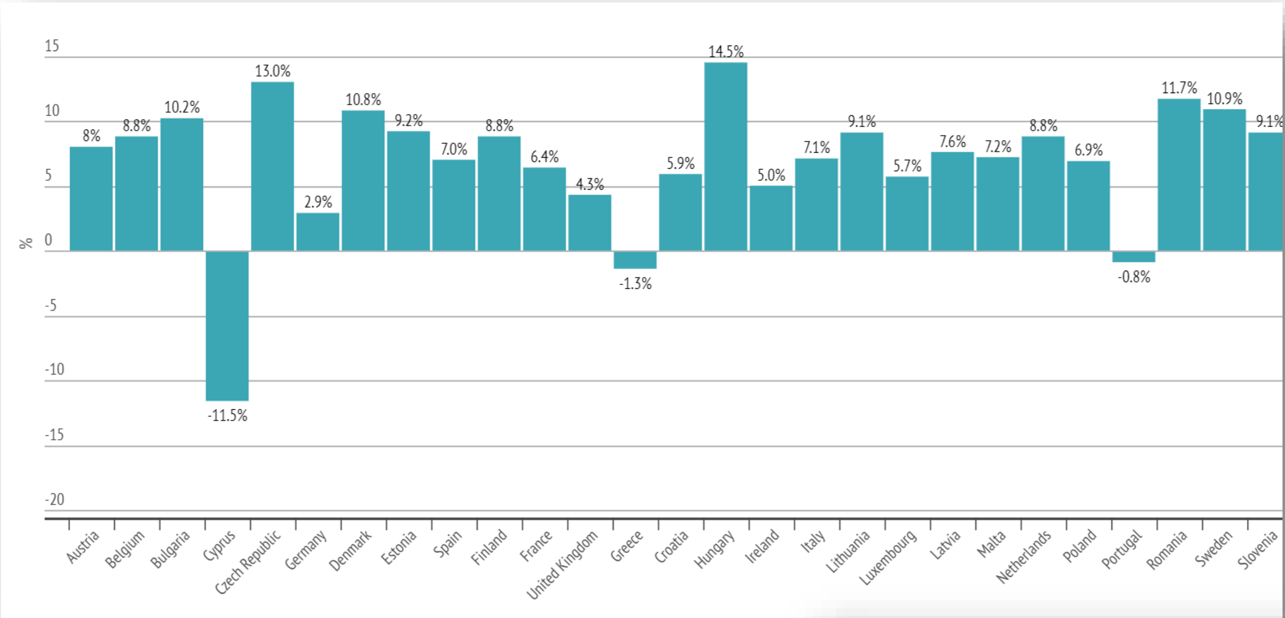


FINANCIAL INTERMEDIATION IS EXPENSIVE

- 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%

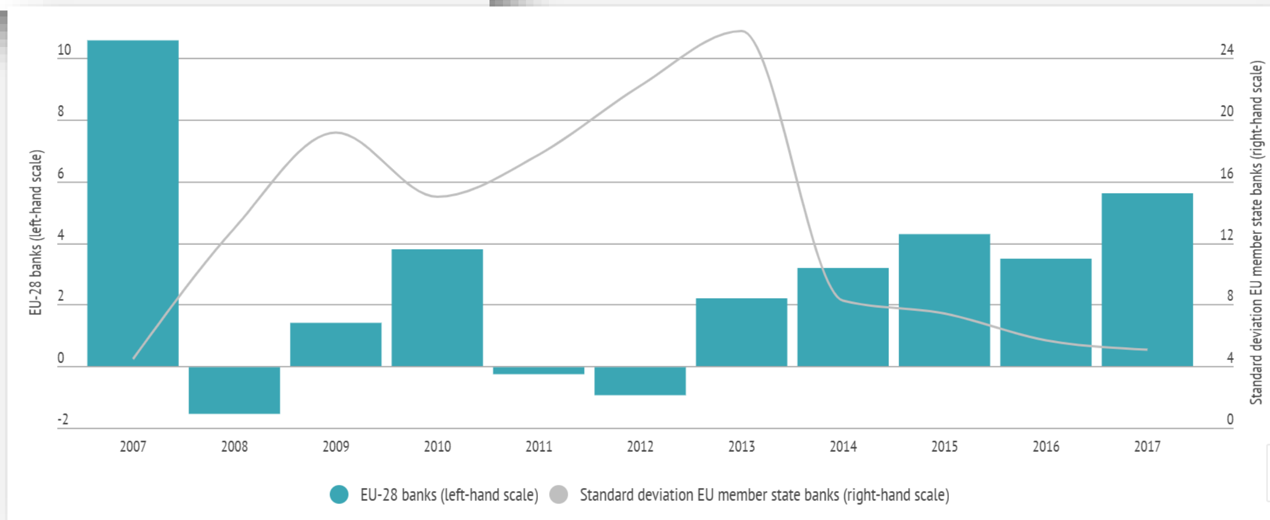


BANKS PROFITS



European Banks’ ROE, 2018
Source: *EBF*

European Banks’ ROE, 2007-2017
Source: *EBF*



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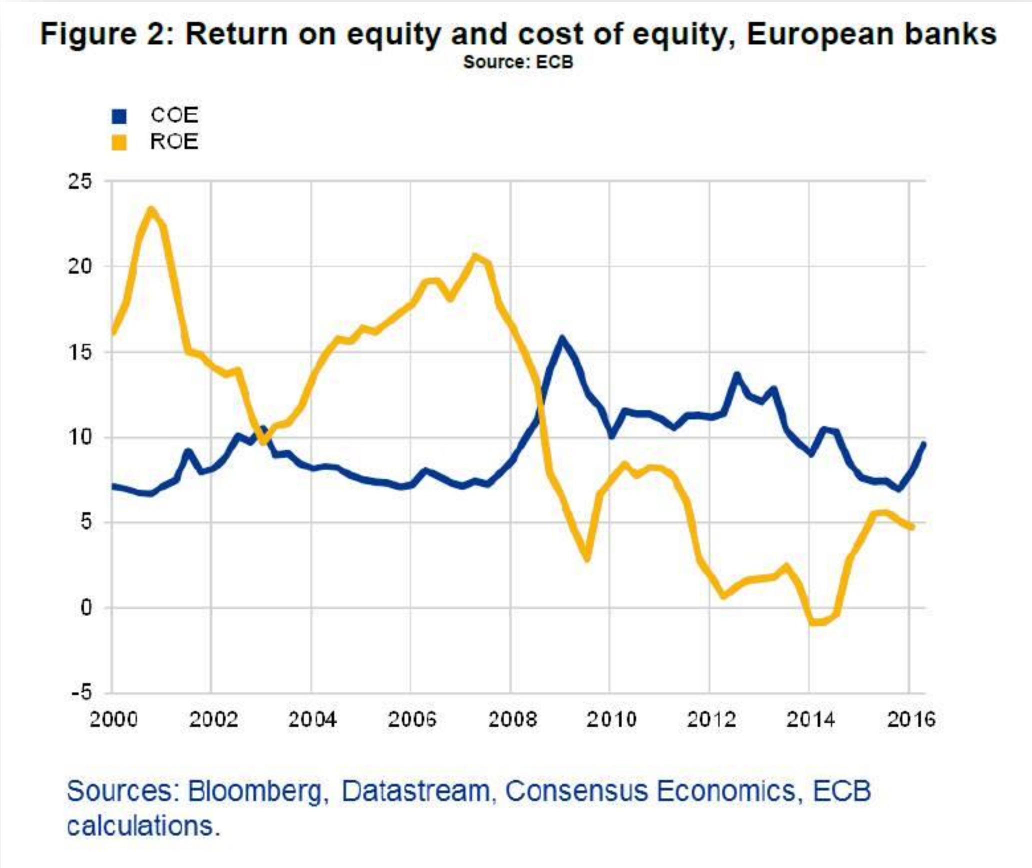

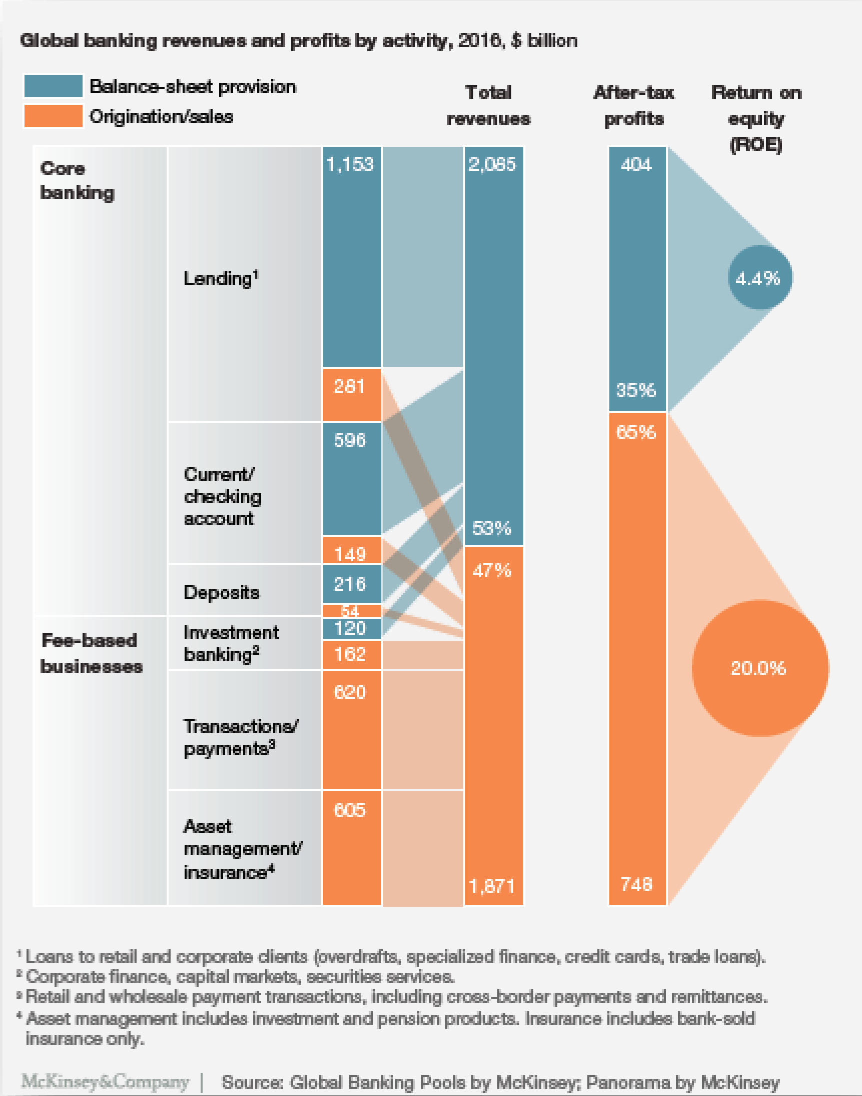

The Digital Opportunity

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

KEY FINDINGS | OVERVIEW

WORLD ECONOMIC FORUM

Fintechs have changed how financial services are structured, provisioned and consumed, but have not successfully established themselves as dominant players

Many fintechs (small, technology-enabled new entrants) came into existence with the goal of overtaking incumbents as the new dominant players in financial services – but have shifted to building partnerships as they struggle with scale and customer adoption

WHERE FINTECHS HAVE SUCCEEDED

Fintechs have seized the initiative – **defining the direction, shape and pace of innovation** across almost every subsector of financial services – and have succeeded as both stand-alone businesses and crucial parts of financial value chains

Fintechs have reshaped customer expectations, setting new and higher bars for user experience. Through innovations like rapid loan adjudication fintechs have shown that the customer experience bar set by large technology firms, such as Apple and Google, can be met in financial services

WHERE FINTECHS HAVE FALLEN SHORT

Customer **willingness to switc** **incumbents has been overesti** switching costs are high, and n often not sufficiently material a new provider, especially as i

Fintechs have struggled to create **new infrastructure and establish new financial services ecosystems,** such as alternative payment rails or alternative capital markets. They have been much more successful in making improvements within traditional ecosystems and infrastructure

CONCLUSION

Fintechs have materially changed the basis of competition in financial services, but have not yet materially changed the competitive landscape

Customer **willingness to switch away from incumbents has been overestimated.** Customer switching costs are high, and new innovations are often not sufficiently material to warrant the shift to a new provider, especially as incumbents adapt*

World Economic Forum, *Beyond FinTech: A Pragmatic Assessment of Disruptive Potential in Financial Systems*, August 2017

BIG TECH PLATFORMS

- 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

- Big Tech Platforms may act as **marketplaces**

KEY FINDINGS | PLATFORMS RISING

WORLD ECONOMIC FORUM

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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Regulation Conundrum

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

BIG TECH PLATFORMS

- 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

IMPLICATIONS

KEY FINDINGS | **SYSTEMICALLY IMPORTANT TECHS**

WORLD ECONOMIC FORUM

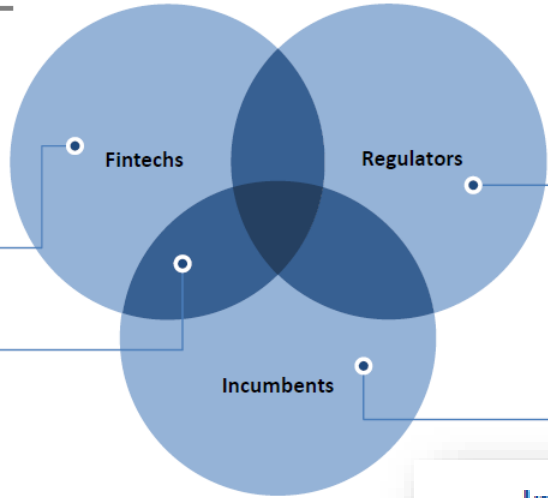
The coming collision between financial institutions and large techs leads to tough choices for all firms: become dependent on large techs or risk falling behind

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 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 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

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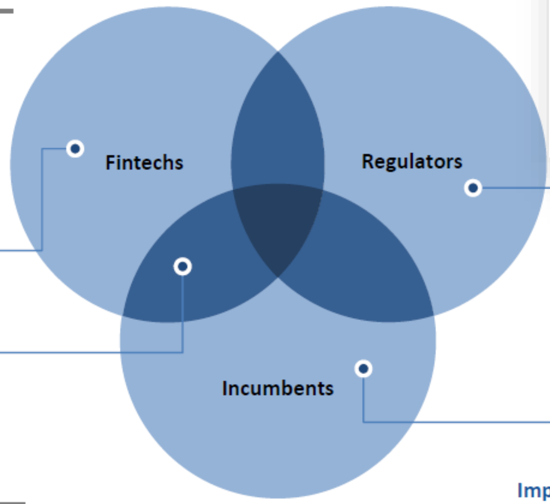

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World Economic Forum, *Beyond FinTech: A Pragmatic Assessment of Disruptive Potential in Financial Systems*, August 2017

Asymmetric Regulation

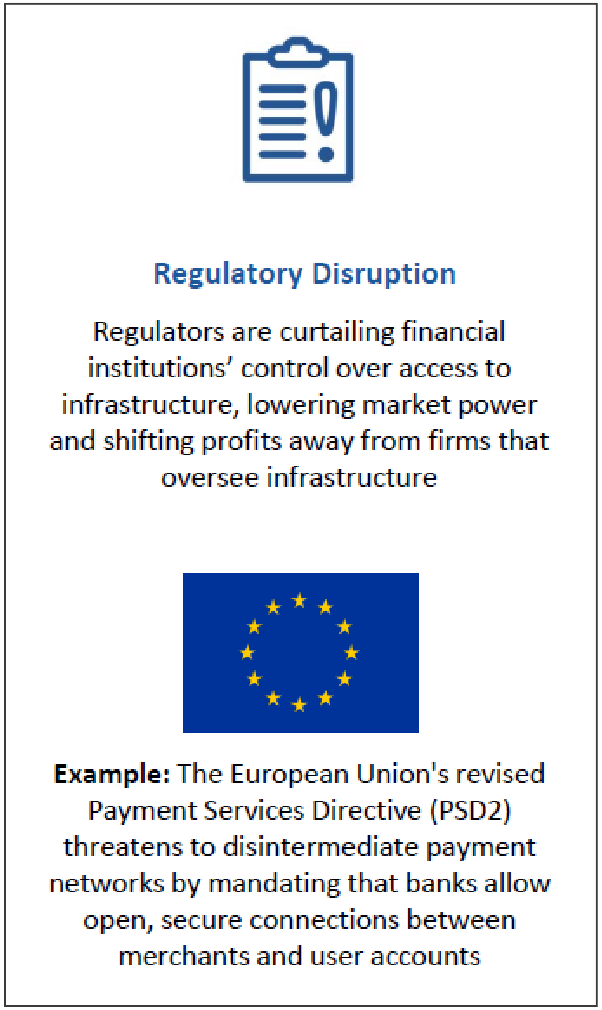
ASYMMETRIC REGULATION

- Philippon (2018):

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



Regulatory Disruption

Regulators are curtailing financial institutions' control over access to infrastructure, lowering market power and shifting profits away from firms that oversee infrastructure

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

World Economic Forum, *Beyond FinTech: A Pragmatic Assessment of Disruptive Potential in Financial Systems*, August 2017

- **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

ASYMMETRIC REGULATION

- **Asymmetric regulation regarding data portability**

PSD2	Vs	GDPR
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 bankin**g 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

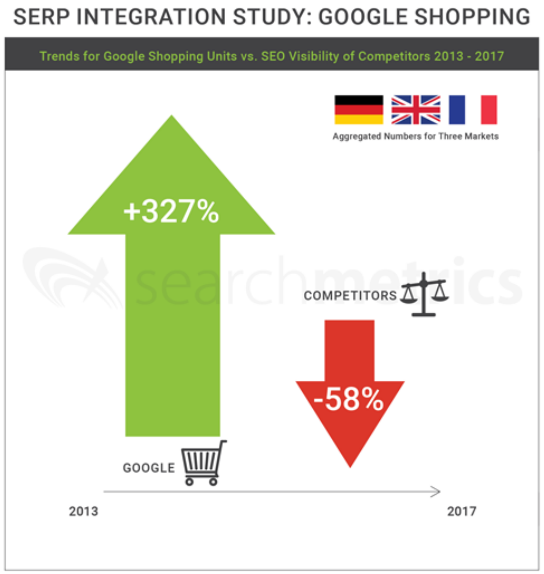
  – **Vertically integrating** upstream and/or downstream

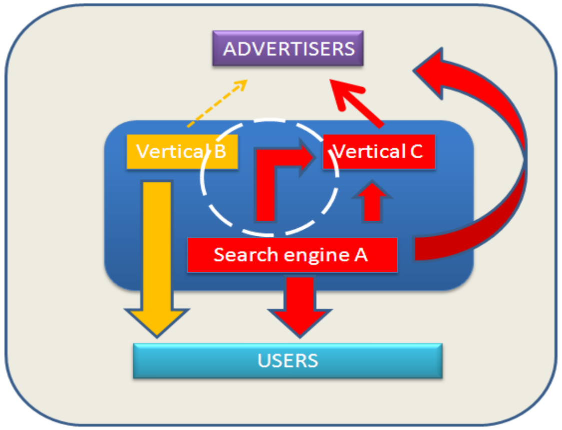
  – **Discriminating** in favour of their own upstream/downstream businesses in their core platforms

  – **Leveraging** dominant services and/or data superiority to attack adjacent markets

VERTICAL INTEGRATION AND PREFERENCING

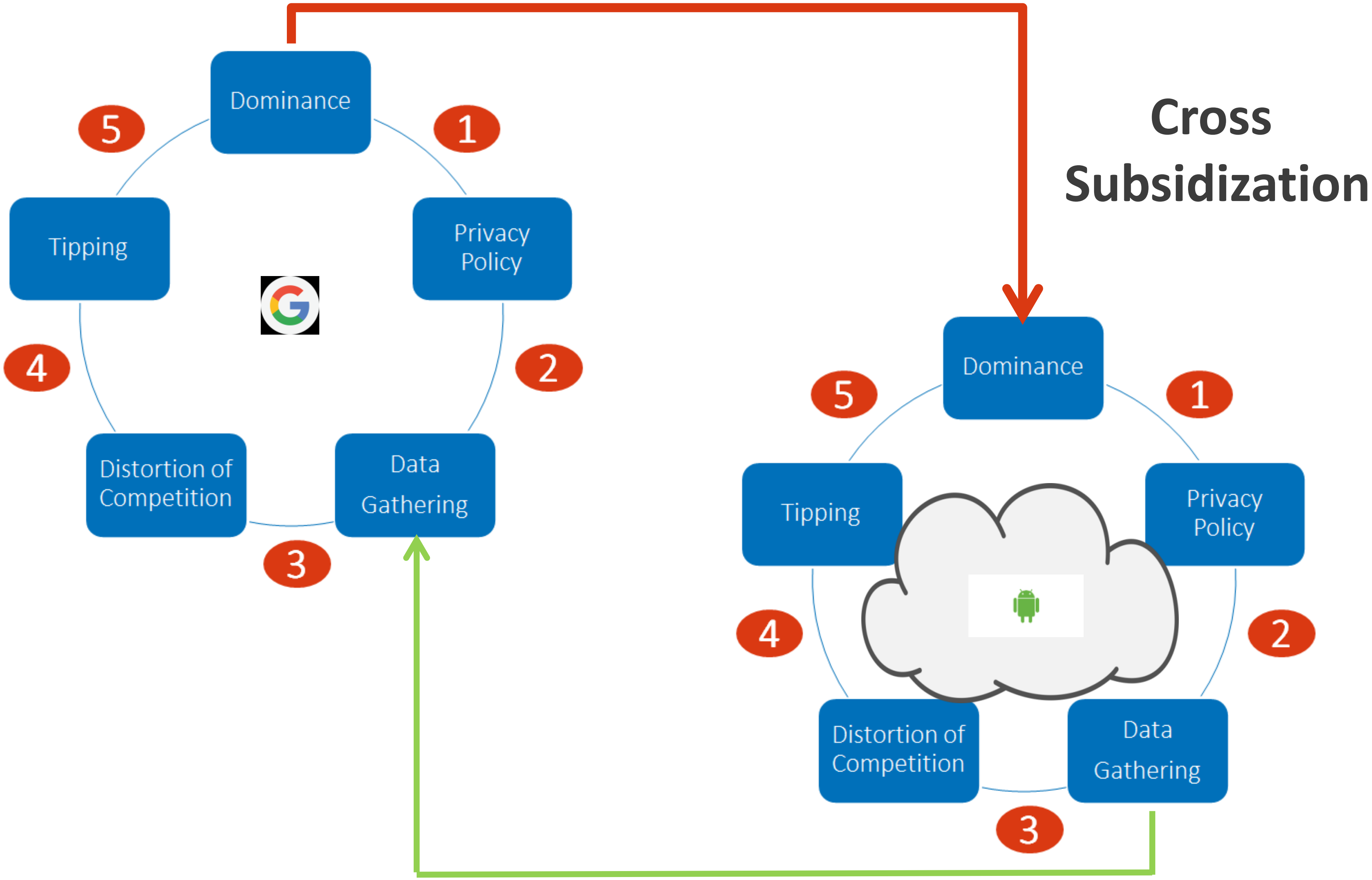
1 **VERTICAL INTEGRATION**



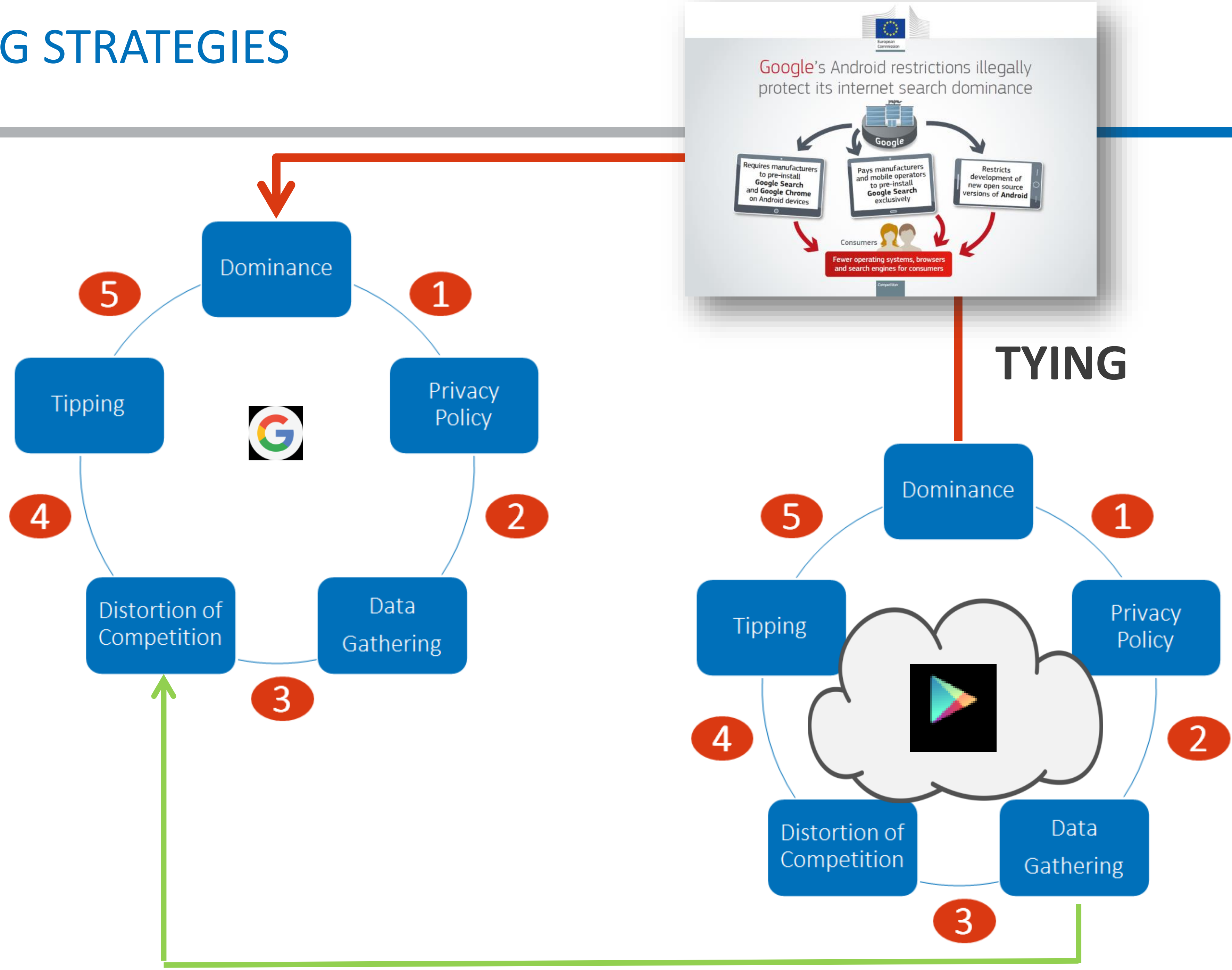


2 **DISCRIMINATION**

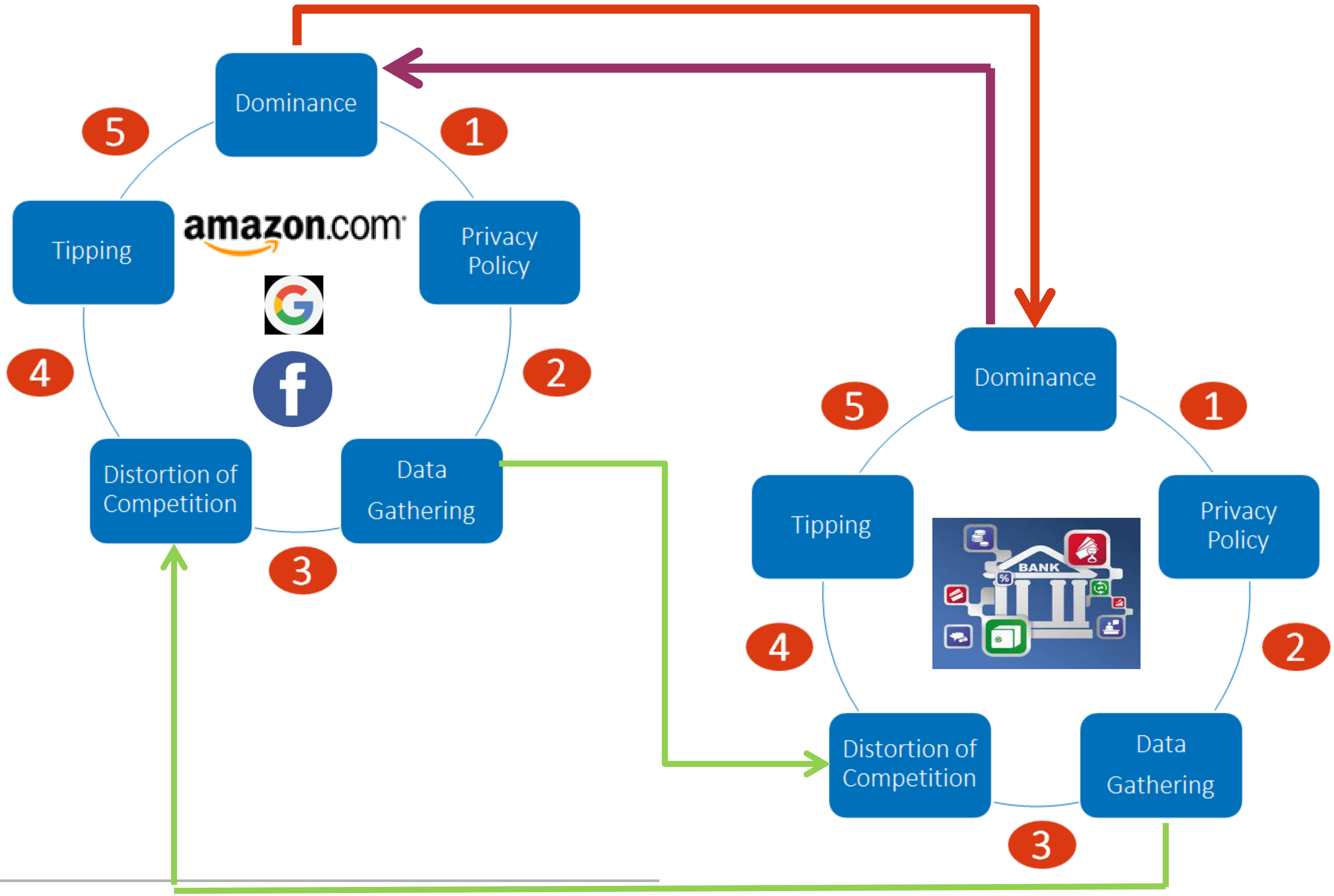
ENVELOPING STRATEGIES



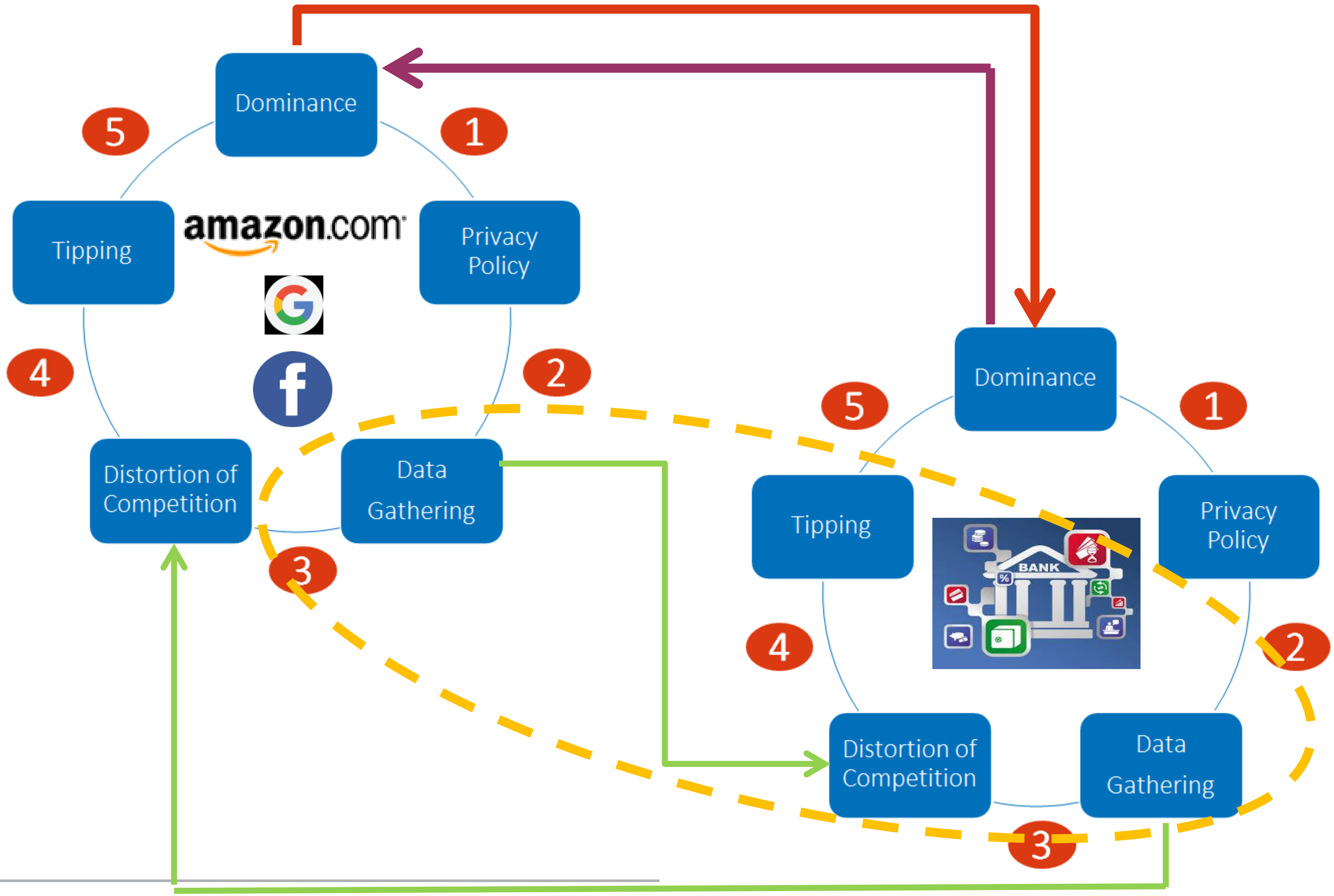
TYING STRATEGIES



LEVERAGING ONLINE PLATFORM POWER ONTO BANKING



ENTRENCHED DATA SUPERIORITY



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.

Speaker: Charles Randell, Chair, Financial Conduct Authority and Payment Systems Regulator
Location: Reuters Newsmaker event, London
Delivered on: 11 July 2018

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

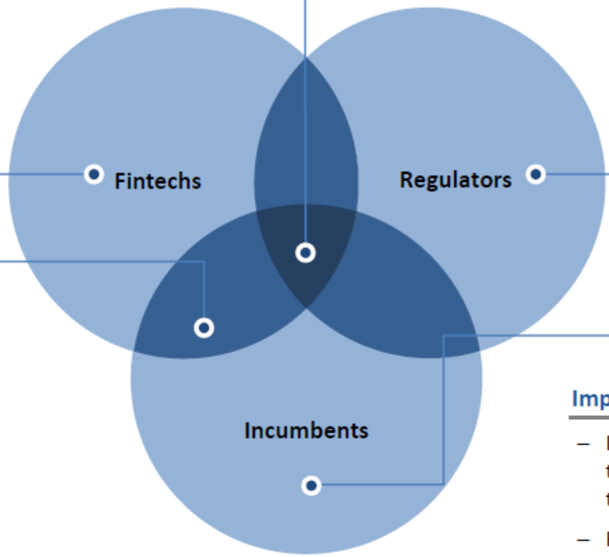
- Fintechs, lacking both an existing customer base and the ability to scale quickly, will have to find niches if they wish to become distributors
- In contrast, distributors may help fintechs compete with incumbents as manufacturers of specialized financial products

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 e
- Questions about how dis and manufacturers share have far-reaching consec



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

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 a decline in product profit margin due to cost commoditization

1

- Product distribution represents a likely point of entry for large tech firms, due to their expertise

3

- Regulators will have to guard against product distributors abusing their market power, especially in open platforms where distributors control the customer shopping experience

2

- However, incumbents that fail to become product distributors will see a decline in product profit margins due to cost commoditization

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

FINANCIAL EXCLUSION

Speaker: Charles Randell, Chair, Financial Conduct Authority and Payment Systems Regulator
Location: Reuters Newsmaker event, London
Delivered on: 11 July 2018

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

NEGATIVE IMPACT OF ASYMMETRIC DATA REGULATION

- 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**

OXFORD ACADEMIC

Article Navigation

Long-Term Debt and Hidden Borrowing

Heski Bar-Isaac, Vicente Cuñat

The Review of Corporate Finance Studies, Volume 3, Issue 1-2, 1 September 2014, Pages 87–122,
https://doi.org/10.1093/rcfs/cfu007
Published: 28 April 2014

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Abstract

Borrowers can raise funds from a competitive banking sector that shares information and from opaque hidden lenders. Hidden lenders allow borrowers to conceal poor results, and thereby affect contracts in the banking sector. In equilibrium, borrowers obtain funds from both sectors simultaneously. The lack of transparency generates cross-subsidies between different borrowers who are observationally equivalent to banks and face the same interest rate. As the cost of hidden borrowing falls, an increasing number of borrowers face identical terms; for sufficiently low costs, all borrowers who take loans (which may include inefficient borrowers) use the same bank debt contract. (*JEL* G21, D82, D86)

Issue Section: Articles

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NEGATIVE IMPACT OF ASYMMETRIC DATA REGULATION

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

Information Technology and Financial Services Competition

Robert Hauswald
American University

Robert Marquez
University of Maryland

We analyze how two dimensions of technological progress affect competition in financial services. While better technology may result in improved information processing, it might also lead to low-cost or even free access to information through, for example, informational spillovers. In the context of credit screening, we show that better access to information decreases interest rates and the returns from screening. However, an improved ability to process information increases interest rates and bank profits. Hence predictions regarding financial claims' pricing hinge on the overall effect ascribed to technological progress. Our results generalize to other financial markets where informational asymmetries drive profitability, such as insurance and securities markets.

Informational considerations have long been recognized to determine not only the degree of competition but also the pricing and profitability of financial services and instruments. However, recent technological progress has dramatically affected the production and availability of information, thereby changing the nature of competition in such informationally sensitive markets. This article investigates how advances in information technology (IT) affect competition in the financial services industry, in particular, credit, insurance, and securities markets.[1] We focus on two aspects of improvements in IT: better processing and easier dissemination of information.[2]

We would like to thank Glenn Ellison, Ulrich Hege, Vojislav Maksimovic, and Maureen O'Hara (the editor) for advice that improved the exposition of the article, and participants at the 2001 Econometric Society Summer Meetings and the 2001 European Finance Association meetings for comments. We are especially grateful to two anonymous referees for suggestions that extended the scope of the analysis. All remaining errors are our own. Address correspondence to Robert Marquez, R. H. Smith School of Business, University of Maryland, College Park, MD 20742, or e-mail: rmarquez@rhsmith.umd.edu.

[1] The consequences of advances in IT can be seen in the birth of on-line banking, the lowering of economic barriers to entry through better means of communication, and in modern credit and insurance risk assessment techniques such as scoring methods.

[2] Shapiro and Varian (1999) also single out these two dimensions of the IT revolution in their discussion of network economics and the role of information in competition. The Federal Reserve Bank of Dallas (1999) estimates that, in the last 30 years, processing power, storage capacity, and transmission speed have multiplied by tens to hundreds of thousands with usage costs falling dramatically.

The Review of Financial Studies Fall 2003 Vol. 16, No. 3, pp. 921–948, DOI: 10.1093/rfs/hhg017
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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 eemedies are not easy

4.2.2009 EN Official Journal of the European Union L 35/47

REGULATION (EC) No 80/2009 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 14 January 2009

on a Code of Conduct for computerised reservation systems and repealing Council Regulation (EEC) No 2299/89

(Text with EEA relevance)

(9) In order to protect consumers' interests, it is necessary to present an unbiased initial display to users of a CRS and to ensure that information on all participating carriers is equally accessible in order not to favour one participating carrier over another.

EUROPEAN COMMISSION
Competition

CASE AT.39740

Google Search (Shopping)

ANTITRUST PROCEDURE

Council Regulation (EC) 1/2003

Article 7 Regulation (EC) 1/2003

Date: 27/06/2017

This text is made available for information purposes only. A summary of this decision is published in all EU languages in the Official Journal of the European Union.

Parts of this text have been edited to ensure that confidential information/personal data is not disclosed. Those parts are shown as […] or replaced by a non-confidential summary, or ranges, in square brackets.

PRIVACY POLICIES

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?

Speaker: Charles Randell, Chair, Financial Conduct Authority and Payment Systems Regulator
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DATA SHARING?

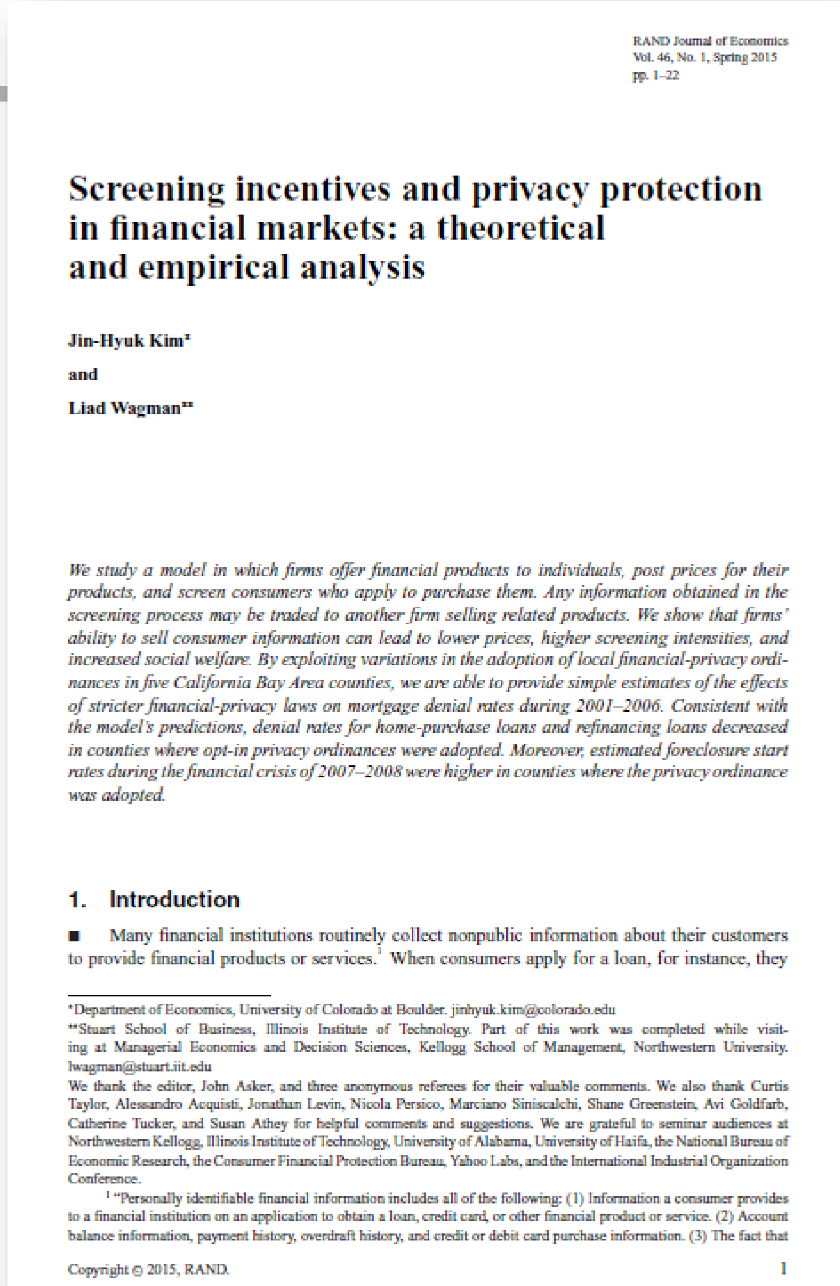
- **Competition Policy**
  - Difficult in Europe:
    - The exceptional circumstances test:
      - Dominance
      - Indispensability
      - Elimination of all effective competition
    - Which remedies?
  - Nearly impossible in the US

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

"Rest assured that your information will not be shared. Now, where can I e-mail the receipt?"

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



RAND Journal of Economics
Vol. 46, No. 1, Spring 2015
pp. 1–22

Screening incentives and privacy protection in financial markets: a theoretical and empirical analysis

Jin-Hyuk Kim*

and

Liad Wagman**

We study a model in which firms offer financial products to individuals, post prices for their products, and screen consumers who apply to purchase them. Any information obtained in the screening process may be traded to another firm selling related products. We show that firms' ability to sell consumer information can lead to lower prices, higher screening intensities, and increased social welfare. By exploiting variations in the adoption of local financial-privacy ordinances in five California Bay Area counties, we are able to provide simple estimates of the effects of stricter financial-privacy laws on mortgage denial rates during 2001–2006. Consistent with the model's predictions, denial rates for home-purchase loans and refinancing loans decreased in counties where opt-in privacy ordinances were adopted. Moreover, estimated foreclosure start rates during the financial crisis of 2007–2008 were higher in counties where the privacy ordinance was adopted.

1. Introduction

■ Many financial institutions routinely collect nonpublic information about their customers to provide financial products or services.[1] When consumers apply for a loan, for instance, they

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**Stuart School of Business, Illinois Institute of Technology. Part of this work was completed while visiting at Managerial Economics and Decision Sciences, Kellogg School of Management, Northwestern University. lwagman@stuart.iit.edu
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[1] "Personally identifiable financial information includes all of the following: (1) Information a consumer provides to a financial institution on an application to obtain a loan, credit card, or other financial product or service. (2) Account balance information, payment history, overdraft history, and credit or debit card purchase information. (3) The fact that

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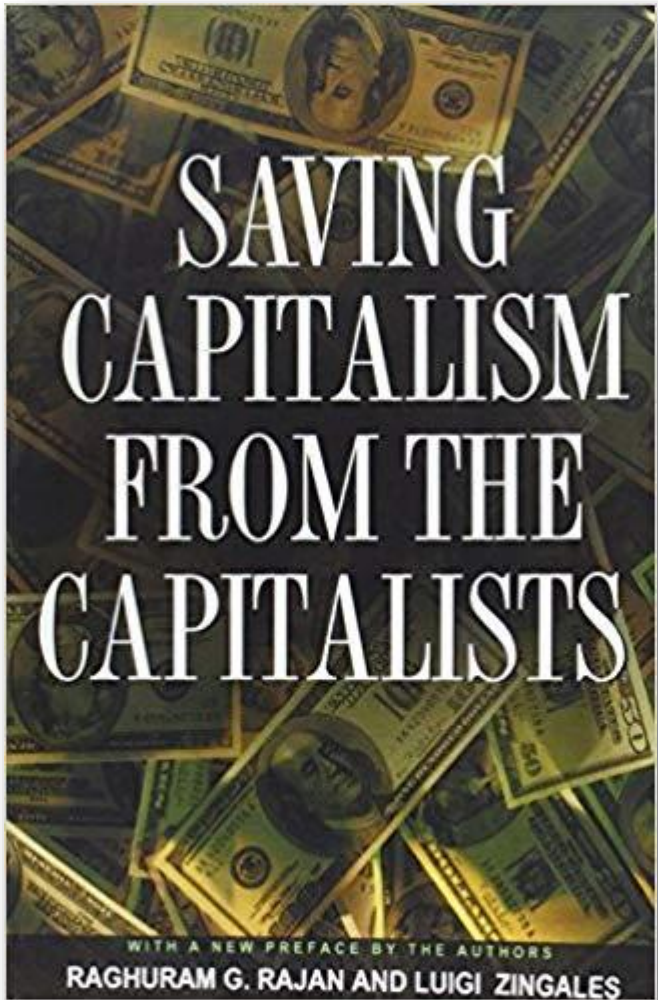
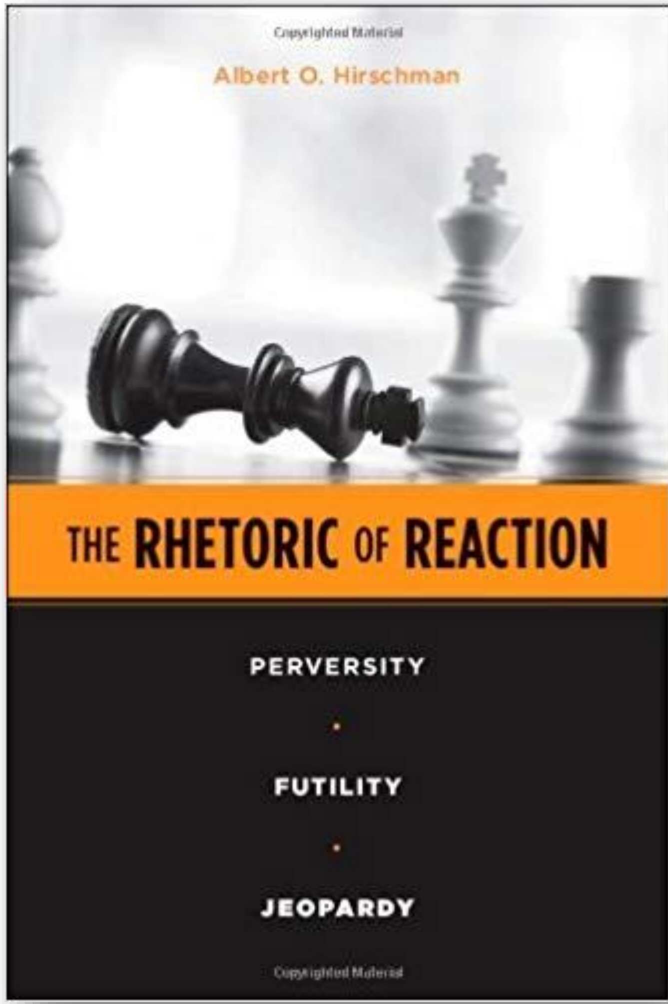
Concluding Remarks

AN IMPORTANT CAVEAT!!





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