Policy proposal under formulation

Sao Paulo, March 20, 2020
CALL FOR PAPERS
Central Bank of the Future 2020
Professor Adrienne Harris
centralbankpapers@umich.edu
735 S. State Street | Weill Hall #5211
Ann Arbor, MI 48109

Ref.: Policy Proposal – proposed regulatory/supervisory process changes that financial regulations could implement to improve financial inclusion

Denis Guimaraes

The call for papers & proposals is expressly soliciting **input from relevant stakeholders**[1], and at the same time acknowledging and/or stating that *i)* many Central Banks have expanded their purview beyond their traditional functions of monetary policy, **financial institution supervision** and **payments** to also cover **financial inclusion**, and that *ii)* the goal of CBOTF is to access the current role of Central Banks worldwide and determine what Central Banks' future role(s) could be in promoting a more inclusive financial system and economy in the context of a **digital world**, with a particular focus on **emerging markets**.

In this sense, following (including but not limited to) the topic *2. Changing the Traditional Remit of Central Banks ● What is the Central Banks' role in regulating non-bank providers of financial services (e.g., big tech, telco)?*, I am submitting a policy proposal titled

Banking regulation and antitrust towards financial inclusion and access to credit

[1] The author submits this policy proposal independently, and is exclusively responsible for its content. However, it should be noted that he has been representing ***Abrasel*** (Brazilian Association of Bars and Restaurants www.abrasel.com.br) since 2017 before the Brazilian antitrust agency, Congress, Ministry of the Economy, and Central Bank. *Abrasel* is an *UNECS* affiliate (National Union of Commerce and Services www.unecs.com.br), and the latter gathers: 13.69% of the Brazilian GDP (*Unecs* gathers BRL 1trillion / USD 200 billion in gross revenues); 65% of the credit and debit card payments; 83.7% of the sales of the food/beverage industry, and; 9.91 million of direct jobs.

Banking regulation and antitrust towards financial inclusion and access to credit

The proposal summarized in the title above actually refers to more than one initiative that is being formulated, implemented, or improved in Brazil. However, it is important to state that this will not be a country specific piece, but rather a comparative case study[2] able to subsidize (a) policy proposal(s) that can be useful to several emerging markets.

Summary of contents / comments:

1. Should central banks be subject to regulatory oversight bodies (ROBs)[3]? If so, of what kind? If not, why?

In addition to the justification provided in footnote 3, the inclusion of this introductory question is explained by the initiative represented by the bill # *PL 6517/2019*, sponsored by a Brazilian Federal Representative with the aim of preventing (competition advocacy) and repressing (abuse of regulatory power) the issuance of anticompetitive regulations that are not based on antitrust exemptions and immunities.

Bill # *PL 6517/2019* was sponsored in December 2019 and is not yet under congressional debate. The author of this policy proposal has advised the Federal Representative on the occasion of the formulation of the draft bill of law on behalf of *Abrasel*, and continues to advise this Association regarding the bill # *PL 6517/2019* issues.

2. How central banks and antitrust agencies interact in selected advanced and emerging markets?

This question shoud be considered in the scope of each of the following procedures, and evidently considering the possible need of prudential[4] regulation measures:

a) Merger reviews;
b) Anticompetitive practices, and;
c) *Competition advocacy* (regulation with competitive impacts).

[2] BARZELAY, Michael. "Design-focused case studies in the professional discipline of public management". *Public Management as a Design-Oriented Professional Discipline*. Cheltenham, UK; Northhampton, MA, USA: Edward Elgar Publishing, 2019, pp. 97-.

[3] "Although regulatory oversight bodies (ROBs) are a relatively new phenomenon in the institutional landscape of the regulatory state, a recent OECD stock-taking exercise counted no less than 163 ROBs in its 39 member states. At least 30 non-OECD countries have also established government bodies tasked with the supervision of regulatory activities and quality control of impact assessment" (KAMKHAJI, Jonathan; FRITSCH, Oliver. "Regulatory oversight bodies: towards a new (meta-regulatory) research agenda. *Panel – ECPR SG RegGov Biennial Conference, Exeter 23-25 June 2021*).

[4] "So far we face an economic crisis, not a financial crisis" (BALDWIN, Richard; DI MAURO, Beatrice Weder. *Mitigating the COVID Economic Crisis: Act Fast and Do Whatever It Takes.* London: CEPR Press, 2020, p. 27.

Latest national/policy references:
- Memorandum of Understanding executed between the Brazilian Central Bank (*BCB*) and the Administrative Council for Economic Defense (*CADE* – the Brazilian antitrust agency) in December 2018 and;
- *BCB* and *CADE* Joint Regulation #1, from December 2018.

It should be noted that the Memo and its resulting Joint Regulation are in line with the Brazilian Senate Bill # *PLS 350/2015 / PLP 499/2018* (the latter is its # at the House of Representatives, where it stands waiting for deliberation after being approved by the Senate).

3. Horizontal concentration, vertical integration, financial inclusion and access to credit

Figure 1 – Main mergers and acquisitions leading to the current 5 biggest banks operating in Brazil

Source: Technical Note # 20/2019/*DEE/CADE*, p. 12.
Notes:
Santander (Spain): #30 Forbes World's Largest Public Companies
Itaú (Brazil): #58
Bradesco (Brazil): #68
Banco do Brasil (Brazil): #154
Caixa Econômica Federal (Brazil): 100% government-owned

Latest national/research reference:

> *"In this paper, we empirically test the two theoretical paradigms in the area of banking competition – the market power hypothesis and the information hypothesis – by evaluating the links between market power and spreads of loans to firms in Brazil.*
>
> *The market power hypothesis claims that higher market power leads to financial constraints and higher spreads. On the other hand, the information hypothesis argues that banks need some market power to reduce the information asymmetry problem in lending markets.* ***According to the information hypothesis, a lower competition induces banks to engage in relationship lending to obtain greater soft information, thus reducing information asymmetries****. Under this view, a higher level of competition reduces the attractiveness of relationships and increases the cost of credit.*
>
> *Using a proprietary dataset of over 13 million observations of private commercial banks loans to firms of all sizes from 2005 to 2016,* ***our empirical results show an inverse relationship between competition and spreads, supporting the market power hypothesis****.*
>
> *Furthermore, we investigate how the relationship between banks and firms is associated with spreads by analyzing* ***switching costs of bank clients and the lock-in effect****. Another key empirical finding is the characterization of the "capture then extract rents" behavior in Brazil. Private banks engage in a strategy of first capturing some of their clients by offering them lower interest rates, and then extracting rents by increasing interest rates as the relationship evolves. This suggests that informational switching costs are helping banks to hold firms as clients. This evidence is also against the information hypothesis"[5].*

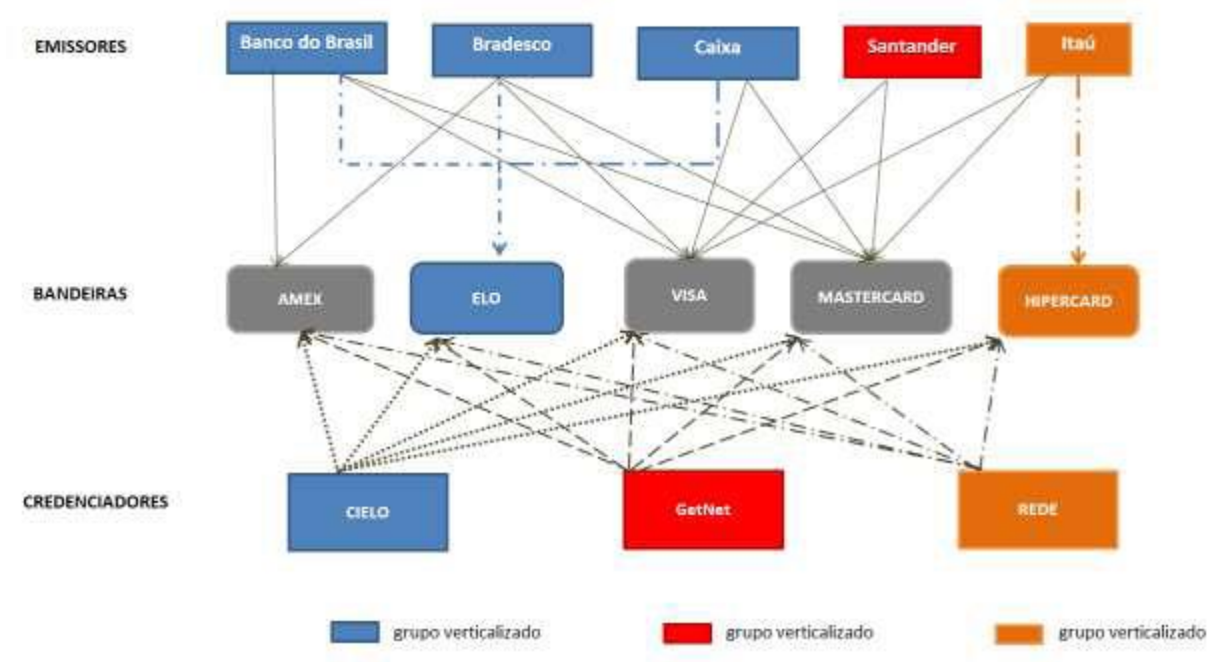
Similarly, evidence from investigations of anticompetitive practices indicates that the vertical integration amongst different services offered in the payments industry does tend to incentivize such practices[6], including in credit markets.

---

[5] ORNELAS, José Renato Haas; DA SILVA, Marcos Soares; VAN DOORNIK, Bernardus Ferdinandus Nazar. "Informational Switching Costs, Bank Competition and the Cost of Finance". *Banco Central do Brasil* Working Paper Series # 512. Brasília, January 2020, p. 3.

[6] The author thanks to Cleveland Teixeira and his *Microanalysis* economic consulting team for sharing their preliminary research: CEPS, *Tying and Other Potentially Unfair Commercial Practices in The Retail Financial Services Sector* – Final Report, Centre for European Policy Studies, 24 November 2009; ESMA, European Securities and Markets Authority Final Report - *Guidelines on cross-selling practices*, 22 December 2015 | ESMA/2015/1861; FED, Federal Reserve System – Proposed interpretation and supervisory guidance with request for public comment, *Federal Register* vol. 68, n. 168, August 29, 2003, p. 52030; NAEGELE, Timothy D. The Anti-Tying Provision: Its Potential Still There, *The Banking Law Journal*, Volume 100, Number 2, February 1983; NAEGELE, Timothy D. The Bank Holding Company Act's Anti-Tying Provision 35 Years Later, *The Banking Law Journal*, Volume 122, Number 3, March 2005; NAEGELE, Timothy D. The Bank Holding Company Act's Anti-Tying Provision Almost 50 Years Later – Part I, *The Banking Law Journal*, Volume 135, Number 6, June 2018; NAEGELE, Timothy D. The Bank Holding Company Act's Anti-Tying Provision Almost 50 Years Later – Part II, *The Banking Law Journal*, Volume 135, Number 7, July/August 2018.

Figure 2 – Main vertical integrations in the payments industry



Source: Technical Note # 20/2019/*DEE/CADE*, p. 20.
Notes:
Line 1 (top): banks
Line 2 (center): credit card companies
Line 3 (bottom): enablers of merchants to accept cards (https://www.bcb.gov.br/en/about/glossary - "payment institution")
Blue vertical group (bottom-up): Cielo / Elo / Banco do Brasil / Bradesco / Caixa
Red vertical group (bottom-up): Getnet / Santander
Orange vertical group (bottom-up): Rede / Hipercard / Itaú

Finally, it must be noted that obviously both horizontal and vertical antitrust issues are significantly impacted by digital non-bank providers of financial services*.*

While the *Economist Intelligence Unit Global Microscope 2019*[7] sums up as a key finding that *the overall enabling environment for financial inclusion has improved globally and Latin America*[8] *and the Caribbean remain the region with the most conducive regulatory environment and infrastructure for financial inclusion*, it is a fact that at least in Brazil key

[7] "Please use the following when citing this report: EIU (Economist Intelligence Unit), 2019; Global Microscope 2019: The enabling environment for financial inclusion; New York, NY", p. 12; see also NAKANE, Márcio Issao et al. "Mobile Payments and Mobile Banking in Brazil: Perspectives from an Emerging Market. In GUIMARAES, Denis A. et al (eds.). *Communications and Competition Law: Key Issues in the Telecoms, Media and Technology Sectors*. Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2015, pp. 135-151; BRAZIL – SENATE. *Report – Working Group – Economic Affairs Commission – Innovation and Competition: new pathways for reducing banking spreads.* Brasilia: December 2018 (only in Portuguese).
[8] https://www.bcb.gov.br/en/financialstability/instantpayments and https://www.bcb.gov.br/content/about/faq/Open%20Banking.pdf, access on 10/19/2020.

digital non-bank providers of financial services are important stakeholders sponsoring antitrust investigations against the 5 biggest banks operating in the country (similarly to *Abrasel* and *Unecs* – footnote 1). On the other hand, there are also situations in which other key digital non-bank providers of financial services have been developing these services jointly with companies controlled by banking groups[9].

4. How can a banking regulation and antitrust agenda survive COVID-19?

As anticipated in footnote 4, COVID-19 brings significant risks to the global financial system, what makes any policy proposal especially difficult at this moment:

> ***Assistance to businesses*** *will require the most creativity.* ***Large-scale lending programmes*** *will be an important part of the response, including partial or full government guarantees of loans made by banks to businesses in order to keep them able to employ people and out of bankruptcy so as to be in a position to resume activity after the pandemic ends – something Germany, among others, has launched. New procedures are needed to enable large-scale workouts and avoid costly bankruptcies and liquidations without relying heavily on government administration. Whether the government should directly cover a large fraction of payroll, as in Denmark, is worth seriously considering. Finally, ensuring banks can extend and pretend on loans while extending new loans* ***will require not just temporary regulatory changes but also backstops for the financial system***[10]*.*

The inclusion of this question in this policy proposal represents more the awareness that COVID-19 might severely impact what central banks (and other bodies) can make in terms of financial inclusion and access to credit – therefore also impacting banking regulation and antitrust policies – than an already consolidated intent of directly adressing COVID-19 and its impacts over the global financial system.

[9] http://en.cade.gov.br/cade-lifts-injunction-that-blocked-the-partnership-between-facebook-and-cielo-regarding-payment-by-whatsapp, access on 10/19/2020.

[10] BALDWIN, Richard; DI MAURO, Beatrice Weder. *Mitigating the COVID Economic Crisis: Act Fast and Do Whatever It Takes.* London: CEPR Press, 2020, p. 195; see also pp. 182, 180, 46, 84, and 147; see also BALDWIN, Richard; DI MAURO, Beatrice Weder. *Economics in the Time of COVID-19.* London: CEPR Press, 2020.