Policy Focus Note 2: Competition Policy in Microcredit Markets

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This Framing Note is the second in a series exploring policy dilemmas which affect financial inclusion.[1] It starts with the observation that microcredit markets in many regions are becoming more competitive; and that this is generally regarded as a good thing for borrowers. However, this may not always be the case: since competition involves winners and losers, the regulator's dilemma in this case is how to encourage healthy forms of competition which do not threaten the stability of the financial system or cause abuse of customers. The Framing Note combines economic theory and competition policy with evidence from credit markets and microcredit in particular to propose ways of navigating the dilemma.

> "Competition naturally distinguishes the competent from the incompetent, the hardworking from the lazy, the lucky from the unlucky. It thus adds to the risk that firms and individuals face... Ultimately, most people are better off, but the ride is not always pleasant, and some do fall off."
>
> **RAJAN & ZINGALES,**
> ***SAVING CAPITALISM FROM THE CAPITALISTS*,**
> CROWN BUSINESS 2003

Introduction

Increasing competition among lenders holds out the prospect that borrowers will benefit from more flexible products, better service and even lower interest rates. Lenders themselves become more efficient and innovative as a result. But, as Rajan and Zingales (2003) note in the quotation at right, competition also increases the risks faced by individuals and firms—for example, building the pressure to lend recklessly in ways which may result in over-indebtedness of some borrowers, or reducing borrowers' incentives to repay when other credit is freely available.

On a large enough scale, such excesses can lead to the failure of lending institutions, including banks which hold customer deposits: this has already happened in some places including Bolivia and South Africa. Even if it does not produce "excess", in the words of *The Economist* (see right), competition may be slow to lead to declining interest rates; slower, that is, than politicians and policy makers would like.

> "...competition has produced success, and a certain amount of excess"
>
> ***THE ECONOMIST***
> 1 DEC 2007, P.42[2]

1. Other Framing Notes in the series will consider policies towards consumer protection, interest rates, and prudential regulation. Clearly, these topics are closely linked, at least in perception if not always in reality. For example, capping interest rates had traditionally been seen as a means of consumer protection; and while competition in credit markets can bring many benefits, it can also result in abuse of borrowers leading to calls for protection.
2. In an article referring to fierce competition among US universities: even not-for-profits can compete!

Facing the risks arising from competition, policy makers are confronted by another example of the "regulator's dilemma" in which they face policy trade-offs without easy answers (Porteous 2006). The dilemma is not whether to allow competition or not, but rather how best to promote "healthy" competition, given the possible negative side effects. Healthy competitive behavior in lending should 1) improve the terms of credit for existing borrowers, 2) broaden access to those who lack it, and 3) contain the negative effects.

Since lenders require incentives to increase their outreach and modify their products to reach new borrowers, access-enhancing competition policy involves balancing the interests of providers and borrowers within the context of overall societal goals. This is far from simple to do. For example, existing customers may gain, at least in the short run, from price reductions or special promotions, but these tactics may be used to preclude entry by competitors resulting in less incentive to grow the market over time: as Carlton (2007: 168) points out:

> *"Deep price cuts benefit consumers but can also drive rivals out of business and set the stage for higher prices. Exclusive territories create incentives for dealers to promote a brand, thereby increasing competition against other brands, but also eliminate competition amongst dealers of that brand. Tying the sale of two products together can be a convenience to consumers but can hobble rivals who produce only one of the products. It is easy to conclude that that one should weigh the costs versus the benefits for each potentially exclusionary practice, but implementing such a test can be exceedingly difficult."*

This Framing Note considers how policy makers are to navigate the dilemma created by increasing competition in consumer credit markets, and in microcredit in particular. It considers first how to define and measure competition; and then looks at the particular features of credit markets, especially microcredit, which raise possible concerns for competition policy. Then, it assesses evidence from a wide range of empirical studies in different countries around the world about the varied observed effects of rising competition in microcredit. Finally, the note describes the range of policy instruments available in the "policy maker's toolkit" to promote healthy competition.

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Understanding competitive forces and issues

In market-based economic systems, competition is an essential condition for ensuring allocative efficiency and for increasing and/or maximizing societal welfare. The two main historical schools of economic thought

regarding competition have viewed the drivers of competition in different ways, and consequently, arrived at different policy prescriptions.

THE STRUCTURE-CONDUCT-PERFORMANCE PARADIGM

In the second half of the twentieth century, neo-classical economists developed the so-called structural approach, which, following empirical observations of various markets, crystallized into the 'structure-conduct-performance' (SCP) paradigm. The SCP paradigm asserts that market structure—the relative concentration of suppliers—drives the competitive conduct of firms, and this in turn affects their profit performance. Above average profitability of firms in a market is a sign of weak competitive forces. SCP remedies this by changing the market structure by reducing the level of concentration. However, it is often unclear that the level of concentration is related to the level of effective competition in a market. Hence, SCP is increasingly viewed as a descriptive rather than a normative approach.[3]

THE CHICAGO SCHOOL APPROACH

Chicago School economists such as George Stigler have argued that a variety of different market structures may still be economically efficient. Under this view, the "contestability" of a market, that is, its openness to potential entry or substitution of the product, is more important than its structure. This approach is therefore more concerned about identifying and reducing barriers to entry.

Despite controversy over its applicability, the SCP paradigm remains influential in policy and judicial circles today: as Cook et al (2003) point out, the resulting rules and procedures to prevent anti-competitive behavior, particularly where market structure is affected by a change such as a merger, may be simpler and easier to apply in developing countries than the measures favored by the Chicago School.

MOVING FORWARD

The mainstream policy debate has generally moved beyond the sometimes simplistic views of causation implied by the SCP and Chicago approaches, and hence beyond their starkly different remedies, towards a greater concern with understanding and measuring what forms of competition are in fact taking place at firm level. Michael Porter (2008) proposed one way of understanding the forces affecting competition in a market in a way that synthesized these views. Porter argues that five fundamental forces, depicted in Figure 1, shape the level of competition in a market. The forces include the nature of inter-firm rivalry, as well as the possibilities of substitution on the demand or supply side and the threat of entry. To understand the overall strength of competition in a market,

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3. Cook et al (2003)

each force must be examined separately. Although Porter's model was originally developed primarily to enable competitors in a market to develop their own competitive strategies (and has been recently reexamined and extended—see Porter 2008), policy makers may apply the analytical framework to achieve a deeper and richer understanding about competition in a particular market.

Measuring competition

Measuring the strength of competition rests first on the definition of the relevant market. At one level, this is easy: "A loose economic definition of a market is that it comprises all products whose presence constrains the price of a particular product to a particular level" (Carlton 2007:161). However, the definition of a market has to incorporate twin dimensions of product and geography.

Some competition authorities use the so-called SSNIP[4] test, also known as the hypothetical monopolist test. This test involves the following thought experiment: assume the presence of a hypothetical monopolist firm in the supply of a particular good. Would the firm find it profitable to raise the price of that good in a significant way (generally defined in developed countries as 5-10%), given that the quantity demanded may fall? If so, this would mean that there were

4. Standing for: small but significant non-transitory increase in price.

Figure 1: Porter's Five Forces Shaping Competition

no significant substitutes which consumers could turn to, and this would constitute a separate market. If not, because consumers were able to turn to other sufficiently similar products, then those products should be considered part of the relevant market. The exercise is generally repeated over a widening set of products until a separate market is found. The same test is applied across distance to test the geographic extent of a market in question—whether local, regional, national or even international.

Performance-related measures consider the divergence of price from a competitive norm.

However, the SSNIP test can be complex to apply in practice. Modern approaches seek to calculate price elasticities—that is, the extent to which the change in price generates a change in quantity demanded or supplied. This provides a measure of the ease of substitutability for consumers and for suppliers in a market. In addition, cross price elasticities may provide a measure of how much the movement in the price of one good may affect the quantity demanded of a different good, therefore measuring the extent to which the goods are complements or substitutes. Carlton in a recent review article (2007) advocates greater use of elasticities as ways to measure market boundaries and effects.

Other measures of market structure or performance are also used. Performance-related measures (such as the Lerner Index, defined as the percentage by which price exceeds marginal cost, which can be hard to measure) consider the divergence of price from a competitive norm. Structure-related measures include:

i. The concentration ratio (often abbreviated to "CR(n)"), which measures the sum of the sales of the largest "n" firms (where n is often a number such as 4) as a percentage of total sales in the market; and
ii. The Herfindahl-Hirschman Index (HHI), which is the sum of squares of the market shares of each of the firms in the market.

In fact, the results of applying these latter two measures are strongly correlated. Both are very sensitive to the size of the denominator (i.e., the relevant market definition), but are often calculated and presented as part of anti-trust proceedings. However, market shares alone are a crude way to estimate market power as a proxy for competition.

Some of the measures described there were applied in the Economist Intelligence Unit's analysis of the competitiveness of microcredit markets in Latin America, highlighted in Sidebar A.

SIDEBAR A

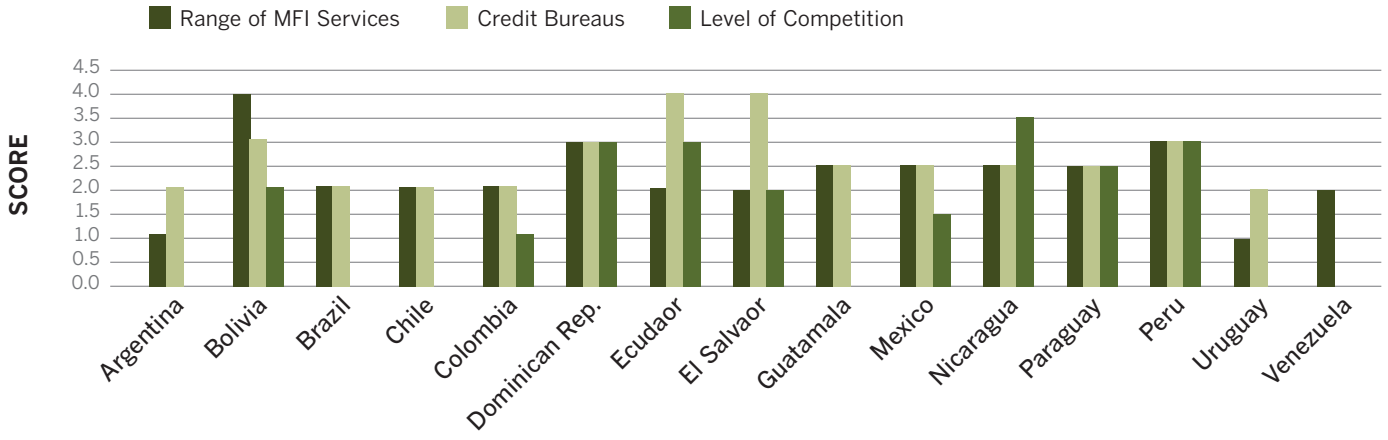
Measuring competition in LAC microfinance markets

The Economist Intelligence Unit recently published a report for IADB entitled *Microscope on the Latin American Environment for Microfinance*.[5] This exercise scored each country based on three dimensions of the microfinance market: the regulatory environment, the investment climate and the level of institutional development. The latter category was broken down into sub-components shown in Figure 2: the extent of competition, proxied by the HHI index, the state of credit bureaus and the level of services provided. By this measure, the level of competition among MFIs was rated as highest in Dominican Republic, Ecuador, Nicaragua and Peru. In general, these are also the countries with higher scores for credit bureau development. It is possible, though not necessarily true, that more developed credit bureaus lead to greater competition (discussed further below). Countries with less concentrated markets also had a larger range of services on offer: greater product diversity and therefore choice for consumers is often an outcome of greater competition in certain market types.

Bolivia provides an interesting but significant exception to these observed correlations: despite having the highest score for the range of services and a relatively high score for credit bureau development, the score for the level of competition there was below average for the nine countries in which competition was rated. However, this outcome likely says more about the inadequacy of the measure of competition used than about the state of competition in Bolivian microfinance, which is generally regarded as fierce.[6]

5. Available via: http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1176139.
6. See for example, Porteous (2005) in which surveys of market participants in Bolivia report fierce levels of competition there.

Figure 2: Institutional development scores for Latin American countries



Note: the score on competition was assessed as follows:
0=Very high score on the Hirschmann-Herfindahl Index (HHI) of 2601 and over (i.e. highly concentrated among a few providers) ;
1=High HHI of 1801-2600;2=Moderate HHI of 1001-1800;3=Low HHI of 501-1000; 4=Very low HHI of 0-500

Rather than seek to measure the intensity of competition, it is often easier (and more relevant) for authorities to look for signs that it is lacking or failing. For example, the UK's Competition Commission lists five indicators which, in some combination and if sustained over time, may point to the need for further investigation of competitive practices in a market:

- high and static prices;
- a lack of product innovation;
- high and sustained profits;
- market share stability;
- low consumer satisfaction.

Some of these indicators were found during the competition enquiry into the home credit market in the UK, described later in Sidebar B.

Microloans share some product features with consumer credit products like credit cards in that they are typically unsecured, generally of low value and short term.

What is the evidence of the effect of competition in microcredit markets?

WHAT IS THE RELEVANT MARKET?

Microcredit falls within the range of credit products offered to individuals, but is it a distinct credit market? Microloans share some *product features* with consumer credit products like credit cards in that they are typically unsecured, generally of low value and short term. Like credit cards, microloans are offered via a range of providers, including banks, non-bank lenders, NGOs or cooperatives. Unlike credit cards, however, some microlending is based on group-based *lending methodologies* involving peer guarantees, monitoring and/or screening. However, in markets outside of South Asia, individual microlending is increasingly more common. Consequently, some of the traditional methodological distinctions which define microloans as a separate product segment are becoming less clear.

Specific product features and methodology apart, microcredit has traditionally been differentiated from consumer credit by the *profile of borrowers* (e.g., self-employed members of low and moderate income households) and/or by the *main usage of loan proceeds* (working capital for microenterprises). Some of these distinctions may have been more apparent than real, however. Whatever the purpose stated at the time of borrowing, microborrowers in fact use the loan proceeds for a variety of purposes, often contrary to the stated purpose. In markets with a weak formal lending sector, clients of microlenders have often had moderate, rather than low, incomes. Microcredit clients have commonly accessed other sources of credit such as informal loans from money lenders alongside their microloans. However, following the success of early microlenders, new and existing formal lenders are more willing to provide

credit to lower income borrowers. For these lenders, there may be little if any practical difference between microcredit and consumer credit.

However, finer grained analysis may show that there remain distinct niches of the credit market which are not subject to pricing pressures across them, qualifying them as distinct markets. For example, although UK borrowers have widespread access to many mainstream consumer credit products, authorities found after thorough investigation of borrower attitudes and patterns that 'home collected credit' (most similar to traditional microlending because of the personal contact between borrower and lender's agent) was in fact a distinct credit sub-market since other sub-markets had limited influence on borrower or lender behavior (see Sidebar B). Similar careful empirical analysis of borrowing patterns, available products and borrower preferences would be necessary in order to define the market for microcredit in a particular context. Microcredit markets may even be distinct within regions or even smaller localities if geographic disparities are wide and if national scale lenders do not exist.

MICROCREDIT FEATURES AFFECTING COMPETITION

Economists have long recognized that credit markets in general have distinct characteristics which make them prone to failure and which affect the competitive behavior of lenders.

Asymmetric Information

The pioneering work of Stiglitz and Weiss (1981) demonstrated how differences in the quality and amount of information between borrowers and lenders could result in lenders being unwilling to lend to potentially creditworthy projects (known as credit rationing). In the presence of asymmetric information, measures such as interest rate caps may bifurcate credit markets into a mainstream credit market, which is subject to regulation and serves borrowers with a defined (low) risk profile, and a parallel market, where borrowers perceived to be higher risk likely receive credit at substantially higher rates, if at all, from unregulated informal sources. Microcredit is typically characterized by such asymmetric information dynamics, as the typical microborrower is not formally employed, has no bank account, no credit record and no formal housing, and thus the conventional sources of information are unavailable to microcredit lenders.

Difficulty of Switching Lenders

Credit markets are often characterized by a large number of lenders of different sizes which compete in part by differentiating their products—a form of competition which economists call "monopolistic competition", where entry to the market is possible in theory at least, and where borrowers can switch lenders. In practice, these conditions do not always

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SIDEBAR B

UK enquiry into home collected credit

In late 2004, the UK's Competition Commission started a formal enquiry into home collected credit ("home credit"). Home credit loans are unsecured loans generally of less than US$1,000 in value and for under one year. Repayments are collected in weekly cash installments from the customer's home, hence the name. Home credit borrowers are generally young, female, have low incomes and live in rented housing. While the value of home credit is small relative to the value of mainstream credit options in the UK, it is nonetheless substantial: over $2.5 billion was loaned to more than 2 million customers in 2005 alone. The home credit sector has attracted considerable negative publicity because of its high pricing, with Annual Percentage Rates generally exceeding 100%. The industry structure is quite concentrated, with one large lender (Provident Financial) constituting around 60% of the market by most measures.

The Commission considered a range of evidence over almost two years before publishing a final report in late 2006. The Enquiry noted mixed evidence in terms of the indicators of competitive intensity: on the one hand, the market shares of major providers had been quite stable over time; these lenders had earned returns "substantially and persistently" in excess of the cost of capital of an efficient lender; and there were modest levels of switching between lenders; however, on the other hand, customers appeared generally satisfied with service and there was some evidence of product innovation. "On balance our findings led us to believe that while home credit provided a service which was valued by its customers, the prices they paid were higher than they would need to be to reflect the costs of providing the service and were higher than they would be in a competitive market." (Enquiry Summary p.8)

The Enquiry considered whether there was sufficient constraint on pricing as a result of competition from other forms of lending or from the threat of entry. While the barriers to small scale entry were low, there were significant barriers to large scale entry or expansion. Assessing evidence from a range of surveys of users, the Enquiry found evidence that, while the penetration of mainstream credit products such as credit cards had increased among home credit users, this did not affect home credit pricing; in particular, as home credit rates had actually increased relative to other interest rates in a recent period, it had not led consumers to switch away from home credit. Therefore, home credit was considered a distinctive market. Competition took place mainly on availability, that is, the ability of a borrower to access a loan quickly and easily. This gave advantages to incumbent lenders who knew existing borrowers better.

Consequently, the Enquiry made a formal finding that there was evidence of an adverse effect on competition in this market. In 2007, the Competition Commission ordered a range of remedies as a consequence of this finding. These included: requiring lenders to share data on all clients through credit reporting agencies, publishing information on prices via an independent website in a way which would facilitate price comparison, the payment of fair rebates on early settlement and prescribed wording on statements including the ability to settle early.

Source: http://www.competition-commission.org.uk/inquiries/current/homecredit/index.htm.

apply and there are several factors that impede switching, beyond simple inertia on the part of customers:

Unavailability of borrower credit records. For example, if the borrower's credit record is not accessible to other lenders (typical with microcredit) it may be harder for her to switch lenders for the next loan.

Low levels of financial literacy. First time borrowers with low levels of financial literacy (typical with microcredit) confronted by complex product information may also be less able to make truly informed choices, and hence less inclined to switch lenders. Even the more financially literate have behavioral tendencies which may be exploited by lenders in ways which increase the effective costs of switching.

Predominance of group-lending. Group-based lending (common with microcredit), which requires that borrowers form groups to be able to borrow, may make it harder still for individual consumers to substitute providers due to the costs of collective action. However, studies in countries where group-lending is predominant in microcredit markets (such as Zohir (2003) for Bangladesh) find that consumers join multiple groups in their individual capacity. The incidence of borrowing from multiple sources may increase as borrowers have more options; and because the other borrowings are undisclosed to lenders, may lead them to make credit decisions based on inadequate or inaccurate information about the borrower's repayment capacity.

Economies of Scale

Costs incurred in the lending process to screen and monitor borrowers may create economies of scale for incumbents, forming a barrier to new entry at scale. Hoff and Stiglitz (1997) note how these features are present in rural credit markets. Under these conditions, they then demonstrated how competition may lead to perverse outcomes: increasing the supply of credit may in fact cause the interest rate to borrowers to rise on average, because the decreased scale causes increased cost per borrower, thereby requiring rates to increase in order to maintain profitability.

Market Share of non-profit lenders

The nature of competition may also be different when not-for-profit providers have significant market share, as is still the case in some microcredit markets like Bangladesh. Since their incentive is not profit maximization (even though they may seek financial sustainability), a NGO's competitive behavior may well differ from that of commercial providers. While Bangladesh's large NGO microfinance institutions compete fiercely on some features such as location and product flexibility, they had yet to compete substantially on price by 2005.[7]

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7. See Porteous (2005)

Government Involvement

The nature of competition may also be affected by the actions of state lenders. As in other markets, the Bangladesh government microcredit apex PKSF has substantial influence over some aspects of MFI competitive behavior, including pricing, through capping margins and controlling the supply of funds to its clients which are retail MFIs.

WHAT FORMS OF COMPETITION DO WE SEE IN PRACTICE?

Porteous (2005) applied to microcredit markets a conventional theory of market development in which different competitive behavior was manifested at different stages of growth. This theory can explain why price competition may not be expected in certain markets until later phases of development; and it was tested using primary evidence of competitive intensity and behavior in three important microcredit markets: Uganda, Bangladesh and Bolivia. At the time, all three countries were considered by local providers and external observers to have increasingly competitive microcredit markets; and in each, some of the negative effects of competition, such as over-indebtedness, had been observed[8], alongside the positive features, such as increasing product flexibility and wider consumer choice.

8. In Bolivia, there were even systemic consequences after a credit bubble burst.

Table 1: Evidence on basis and effects of competition in different microcredit markets

FINDING	COUNTRY (SOURCE)
1. Competition provides benefits to customers in stages: first on access, then service, then price.	Kenya (Johnson 2003), Uganda (Wright & Rippey 2003); Pakistan (Burki & Shah 2007)
2. The degree of information sharing available about borrowers is critical to the outcome of competition.	Uganda, Guatemala (McIntosh et al 2005, 2007)
3. Competition may lead to increased efficiency but may be unstable.	Bolivia vs Peru (Portocarrero & Byrne 2003)
4. Competition may lead to multiple indebtedness of borrowers, resulting in lower repayment rates.	Bolivia (Vogelgesang 2003), Bangladesh (Zohir 2003); however, in India, Krishnaswamy (2007) finds that this is not the case.
5. More concentrated markets may in fact have more, not less, competition (i.e. contrary to SCP approach).	Bolivia vs Peru (Portocarrero & Byrne 2003)
6. The social outcome of competition is ambiguous: competition leads to innovation but reduces the ability of lenders to cross-subsidize less profitable smaller loans.	Bolivia (Navajas et al 2003)

Across the three countries, only in the case of Bolivia did microcredit interest rates substantially decline (measured properly in real terms and relative to average commercial bank lending rates over time). And this decline had started much earlier than predicted by the market development model. On closer investigation, price competition set in sooner there because two dominant pioneering lenders competed fiercely on a wider basis than usual (for example, on methodology, i.e., group versus individual lending, rather than product features, from the outset). Price competition quickly became part of their differentiation strategies. However, in contrast with Bolivia, in a relatively mature market like Bangladesh, interest rates appeared to be "stuck", albeit at a relatively low level in global terms. In Uganda in 2005, a less mature market, microcredit spreads had yet to exhibit a clear downward trend.

Several studies have assessed different aspects and outcomes of competition in a range of countries, as summarized in Table 1. In general, the intensity and basis of competition among microcredit varies over time and by country; and while there is strong evidence of positive effects in many places, certain studies from Latin America such as Vogelgesang (2003) and Navajas et al (2003) sound notes of caution regarding possible negative side effects.

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Remedies: the Regulator's Toolkit

Policymakers have several instruments in their "toolkit" with which they may address anti-competitive practices and patterns. This section discusses the main approaches in turn.

DIRECT COMPETITIVE LENDING BY PUBLIC INSTITUTIONS

If private lenders are not competing effectively, then a state-owned institution may be used to inject new forms of competition into the market, for example, on price or type of borrower. While support for the direct state provision of microcredit has declined in many places due to its demonstrated lack of sustainability, some older and larger microcredit programs remain state-backed[9]: Indonesia's BRI reports some 3 million microcredit clients; and in Latin America, Banco del Estado de Chile has over 200,000 clients. Both of these programs have been pioneers in their own countries, promoting sustainable models of microfinance and operating within internationally acceptable default parameters. State-ownership itself may therefore not be the main issue, but rather whether the institution is able to maintain a sustainable lending approach without causing negative market distortions.

Other than the two examples above, state-owned financial institutions in many places are less free to pursue sustainable policies; so using them

9. See article by Bate in *Microenterprise Americas* 2007, p.16-18.

as challengers to provoke competition by private players is a risky strategy indeed, which could carry large fiscal consequences from failure, and may crowd out private providers, further reducing supply to the market. It may not even sustain the directly targeted objective, like lower rates.[10]

Government regulation, embodied in licensing requirements to enter a market, may constitute a barrier to entry.

Reducing barriers to entry

Barriers to entry in any market may arise from various sources. Depending on the source identified, the policy maker may have different ways of reducing the barrier so as to make the credit market more contestable.

- *Scrutinize pricing policies and patterns*
  As discussed in the previous section, certain aspects of the lending process on the supply side are subject to economies of scale, including the collection of information about clients and the credit screening process. A new or small firm which does not have enjoy the benefits of scale may find it hard to enter the market successfully if incumbent firms exploit their scale advantages by lowering prices to pre-empt entry or eliminate a competitor. Regulators therefore have to look carefully at pricing policies and patterns, especially of larger lenders, to ensure that the intent is not anti-competitive.

- *Monitor network effects*
  On the demand side, certain credit products like credit cards exhibit network-like features: the cards are more valuable the more widely they are accepted. These aspects of credit card schemes have resulted in competition authorities in various jurisdictions, including EU, UK, Australia, Mexico and South Africa, subjecting them to increased scrutiny in recent years.[11] Regulators have consequently paid more attention to the levels of interchange fees set for transactions across network members, and to the terms of access to these networks.

- *Support the formation and growth of credit bureaus*
  High switching costs make it harder for customers to change to a new supplier which offers better terms. In the absence of a credit reference bureau which makes their track record accessible and "portable" to other lenders, borrowers may be unable to switch to a new lender. Equally, the absence of ready access to borrower histories constitutes a barrier to entry for new lenders. The introduction of a credit bureau which enhances the portability of both good and bad credit records can therefore bring substantial advantages to lenders and borrowers. Luoto et al (2007) and McIntosh and Wydick (2007) demonstrated this using a randomized field experiment following the introduction of a credit bureau in Guatemala. The effect of better screening of risky borrowers, and even to some extent, the positive incentive effect on borrowers who know that their record is now being monitored, reduced the risk of

10. As Hoff and Stiglitz (1997) showed: supplying more state credit at cheap rates to rural areas may in fact increase the general interest rate, rather than decrease it.
11. For a summary of the competition issues arising in card markets in particular, see "Competition Policy Issus in Retail Payment Systems", BFA, March 2009, Issues paper prepared for DFID

default to the lender. For this reason, the UK's Competition Commission ruled in 2007 that home credit lenders must in the future submit borrower profiles to a credit reporting agency (see Sidebar B).

- *Avoid onerous licensing requirements*
  Government regulation, embodied in licensing requirements to enter a market, may constitute a barrier to entry. These may take the form of high minimum capital requirements or an approval process which adds delay and cost for entrants. Typically, where lenders are required to be licensed for their lending business (rather than, say, as deposit taking entities), the capital and general entry requirements are relatively light.[12] For example, the South African National Credit Act of 2005 sets low qualification requirements on lenders and imposes a registration fee which varies with size such that it is not onerous on small lenders. This reflects the general situation in most jurisdictions that there are already many lenders of differing sizes so that an onerous formal registration requirement is hard to enforce. However, if lenders are also deposit taking institutions, then they face much more onerous regulatory barriers to entry because of the additional prudential and systemic risks. Regulators need to evaluate whether the requirements for entry to a particular regulated market (e.g., credit as distinguished from deposit taking) are unduly onerous for that particular activity so as to constitute an unnecessary barrier to entry which protects incumbents.

In addition to considering how these factors affect the height and extent of barriers to entry, policy makers must consider expected retaliatory tactics which incumbents do or could use. To make markets more contestable, competition law may explicitly prohibit certain forms of retaliatory behavior such as artificially lowering prices to deter or squeeze out a new entrant. This is taken up in the next section.

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COMPETITION POLICY

While we have up to now considered general policy measures to improve competition, competition policy and law has become a specialized domain in itself, following laws introduced in the US and Canada over a century ago. Specific competition laws are new or not yet present in many developing countries, although they are increasingly common (Cook et al 2003). The capacity to enforce them is however often still limited. Unlike price regulation (such as price controls) or borrower protection laws, which are applied ex ante, anti-trust or, more generally, competition law is usually applied ex-post at a particular time when some condition has been violated: "anti-trust is designed to let markets work when they can work. Regulation is specific, setting rules for prices and quantities. When markets fail—as in the case of natural monopolies—anti-trust is not a substitute for regulation" (Carlton 2007: 173).

12. Civil code countries are often an exception to this, creating substantial barriers to entry for formal lending.

An integrated legal framework for regulating credit may help to stabilize an emerging credit sector by driving out bad practice, and encouraging reputable lenders to enter the market. This may increase competition; although not necessarily in all the desired ways—as the case of South Africa in Sidebar C shows, for example.

An integrated legal framework for regulating credit may help to stabilize an emerging credit sector by driving out bad practice, and encouraging reputable lenders to enter the market.

SPECIALIZED "COMPETITION" REGULATORS

Because financial sector regulation is pervasive and complex, competition issues in banking and financial services have often been left in the domain of the prudential regulator, rather than the competition authority, if there is one. Having a specialized competition regulator is a relatively new phenomenon in many developing countries, as Table 2 shows: Mexico's Commission has been in existence since 1993, while India established its Commission only in 2003. In some places, the banking sector was even exempted from general anti-trust law. However, there is growing recognition that competition in these sectors should fall under the specialist competition authorities (Biggar and Heimler 2005). This is because these agencies are better equipped to consider the competitive issues without being unduly affected by prudential or systemic concerns, even though they are required to consult and co-operate with sectoral regulators in reaching their decisions. Following this trend, a number of competition regulators, including those in Mexico, South Africa and the UK, have undertaken recent investigations of patterns and outcomes of competition among banks.

SIDEBAR C

Regulation, market structure and performance of new credit markets in South Africa

The absence of appropriate regulation can cause credit markets to bifurcate or fragment. Reputable "mainstream" credit providers may stay out of a higher risk market segment because of the threat that regulatory action (such as capping interest rates) will make it unprofitable or because of adverse reputation effects in being associated with other providers whose market behavior attracts unfavorable public attention. This would reduce competitive pressures in the higher risk segment, making it more likely to experience troubling lender conduct. Bringing all lending behavior under one unified and effective regulatory umbrella should help to reduce the risk of this rift. This was part of the logic of creating the MicroFinance Regulatory Council (MFRC) in South Africa in 1999. All lenders – large and small, bank and non-bank – were required to register and comply with sound lending rules if they wished to enjoy an exemption from price caps on small loans. The MFRC was charged with policing the behavior of its member lenders.

A review undertaken by consultants ECI in 2005 found that this unified regulatory structure had indeed helped to encourage entry into formal microlending by large banks and even furniture and clothing retail chains. By 2004, nine banks were registered to do microlending and contributed almost half of the value of loans written.

Undertaking investigations of patterns of competition in a sector can be resource intensive, but, since the authorities may have the legal power to subpoena evidence, enquiries may bring to light information not normally available. This approach has been used in the UK in recent years, especially to consider the complex questions introduced by new technologies and retail payments systems. After a comprehensive review spanning several years, the Cruikshank Commission found evidence of anti-competitive practices, among other things, in the UK's retail payments systems. A special Payment Systems Taskforce, chaired by the Office of Fair Trading, was established in 2004 to consider necessary changes in consultation with the industry. This Taskforce wound up in 2006, having proposed and overseen the implementation of far reaching changes which improved competition in UK payments.

However, other than the review of the UK home credit market, summarized in Sidebar B, and apart from investigations of the rules and pricing arrangements of credit card networks (which have anyway focused more on the payment network elements than the credit offering), consumer credit markets have in general not been as carefully scrutinized by competition authorities as other markets in the financial sector[13]: their diverse and fragmented nature makes it a priori less likely, but by no means impossible, that specific anti-competitive practices exist.

Financial sector policy should encourage healthy competition in microcredit markets.

13. For example. a special enquiry by the Competition Commission of South Africa finally reported in December 2008, following a two year investigation into patterns of retail bank fees and pricing of payment instruments.

Table 2: Specialized Competition Authorities

	INDIA	MEXICO	SOUTH AFRICA	UK
Specialist competition regulator (date of formation)	Competition Commission (2003)	Comision Federal de Competencia (1993)	Competition Commission (1998)	Office of Fair Trading/Competition Commission (1999)
Jurisdiction over banking sector	No—RBI	Yes	Yes—joint with Registrar of Banks	Yes
Has there been a a recent special enquiry about the banking	No	Yes—report to President in 2007	Yes—Banking Enquiry into bank fees (2006-08)	Yes—supply of banking services to SMEs (2000-02); home credit (2004-06)
Source	http://www.competitioncommissionindia.nic.in/	http://www.cfc.gob mx/	http://www.compcomco.za/	http://www.competitioncommission.org.uk/

Conclusion: navigating the dilemma

Financial sector policy should encourage healthy competition in microcredit markets. Policy makers have at their disposal a range of instruments which can be used to pursue this goal.

The starting point for navigating the dilemma of competition policy is to define *healthy competition*, in sufficiently clear terms so that the intensity of competition can be assessed and monitored over time. At a minimum, it means the absence of prohibited anti-competitive behavior: when such behavior is reported or identified, authorities should investigate, and if warranted, penalize it.

SIDEBAR D

Competition and interest rates in the long run: evidence from the market for credit cards in the USA

There are very few reliable time series of market structure, conduct and performance ("SCP") data which enable one to see the long run effects of competition in microcredit markets in developing countries. However, arguably, the credit card market in developed countries shares at least some of the same characteristics—a short term, unsecured credit product, accessible to lower income groups. Access to and use of credit cards has massively expanded in developed countries like the U.S. over the last three decades following liberalization of interest rate and other restrictions in the early 1980's. Under the Fair Credit and Charge Card Disclosure Act, the Federal Reserve Board is required to submit to Congress an annual report on the profitability of the credit card operations of depository institutions. In July 2007, the seventeenth such report was filed using information from bank call reports and special credit card interest rate surveys. This report found that:

- **Structure:** there has been considerable consolidation in market structure through the acquisition of portfolios by larger lenders and through mergers. The largest 10 issuers control 90% of the cards in issue; while the market for acquiring merchants is also highly concentrated (one firm, First Data, is estimated to process 50% of Mastercard and Visa transactions from merchants in the US, although acquiring banks take the risk).
- **Performance:** since the early 1980's, when credit card banks (banks with the bulk of their loans to individuals and 90% or more of consumer lending through credit cards) were first licensed in the U.S., large U.S. credit card banks have consistently been more profitable than depository institutions as a whole.
- **Conduct:** thousands of firms compete in this market, using a variety of differentiating strategies; and the Fed observes that the basis of competition has evolved since the early 1990's from waiving annual fees and enhancing program benefits to experiencing much greater interest rate competition. The Federal Reserve survey collects information on card interest rates based on the simple average across all accounts; and the average rate paid by those who incur finance charges. The data indicate that "credit card interest rates fell sharply from mid-1991 through early 1994 after being relatively stable for most of the previous twenty years, and fell again over the 1998-2003 period" (p.4).

However, a more pro-active approach would go further to look at diverse characteristics. For example: healthy competition takes place:

iii. across different product characteristics or bases (i.e., not only in one feature such as service level or location or price, but across the bundle represented by the offering);
iv. at an intensity appropriate to the stage of market development; and
v. in a way which is likely to lead to the achievement of societal goals, such as broadened access to sustainable credit.

This definition requires that lenders compete extensively (through new products and distribution channels to target new client segments) and intensively (among existing clients). In addition, policy makers usually wish to see competition on interest rates as a manifestation of healthy competition. As shown earlier, price competition in credit markets may usually start only at later stages of development but it is more likely to start earlier if there is a diversity of lenders with different strategies in the market, than if one product type or lending approach prevails. Competition policy should be directed toward encouraging these market conditions.

In the long run, a healthy credit market is likely to deliver better products, higher quality service, higher levels of access, as well as lower relative interest rates. One example of a credit market in which competition has resulted in much greater access, together with diverse products and generally lower rates to mainstream borrowers, is the credit card market in the U.S. Sidebar D describes some of the long term effects of competition in this market. Although credit cards differ from microloans (because the card offers transactional capabilities), credit cards increasingly compete with microcredit in some developing markets as a flexible line of credit for individuals and small businesses.

Competition took a while to gather momentum in this market: while credit cards were introduced in the U.S. in the 1950's, only from the 1970's did usage and access increase rapidly. Although the underlying credit card product is essentially similar among all lenders, competition has long taken place on the basis of differentiated product features. Only in the 1990's (forty years after launch) did price-based competition set in. This followed the entry of new mono-line card lenders which used marketing strategies different from those of the incumbent commercial bank issuers. Increased access, greater choice, even lower rates for at least the majority of customers are positive fruits of competition. However, this market also shows one of the clear negative signs of competition listed earlier: the sector is beset with claims that aggressive marketing and reckless lending by some lenders has led to over-indebtedness.[14] This factor combined with economic slowdown has caused rising stress in the default performance of credit card loan portfolios.

As microcredit evolves over time as a segment of the broader personal credit market...even in the long run, the dilemma of how to promote healthy market development through healthy competition does not easily or soon go away.

14. See Mann 2006.

As microcredit evolves over time as a segment of the broader personal credit market, this example from another developed market shows that, even in the long run, the dilemma of how to promote healthy market development through healthy competition does not easily or soon go away. But policy makers can seek the knowledge and tools with which to better navigate the dilemma in microcredit.

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