Submission by the Commissioner of Competition before the Department of Finance Canada, Potential Policy Measures to Support a Strong and Growing Economy: Positioning Canada's Financial Sector for the Future

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October 12, 2017

Introduction

1. The Commissioner of Competition (Commissioner) is pleased to make this submission in response to the Department of Finance Canada's (Finance Canada) consultation paper, "*Potential Policy Measures to Support a Strong and Growing Economy: Positioning Canada's Financial Sector for the Future*" (Consultation Paper).

2. The Competition Bureau (Bureau), under the direction of the Commissioner, enforces and administers the *Competition Act*, and is responsible for ensuring that Canadian consumers and businesses prosper in a competitive and innovative marketplace. Section 125 of the *Competition Act* gives the Commissioner authority to make representations in respect of competition to boards, tribunals, and other entities carrying on regulatory activities. It is in this context that the Commissioner makes this submission.

3. The Commissioner applauds Finance Canada's efforts to consult Canadians on how best to position the financial sector for the future. In a time of rapid innovation, it is important that regulation keep pace, and that it provide adequate freedom for market competition to deliver market outcomes.

4. The Bureau's operating assumption is that competition is good for consumers and business. As such, regulation should be minimally intrusive to ensure that market competition is not inhibited or prevented unduly by regulation.

FinTech market study

5. The Bureau is completing a market study into technology-led innovation and emerging services in the Canadian financial services sector (the FinTech market study).

6. The FinTech market study focuses on the barriers to entry and growth faced by firms—incumbents and new entrants—to introducing new financial technology products and services. At times, these barriers are attributable to regulation; at others they are not, but may require regulatory intervention to be reduced or eliminated.

7. The Bureau encourages Finance Canada to consult the Bureau's upcoming FinTech market study report, which will be released for public consultation in November 2017. Additionally, the Bureau held a FinTech workshop in February 2017, and recommends Finance Canada consult the workshop summary report.

8. During the course of the FinTech market study, the Bureau consulted with industry and government stakeholders to gain a better understanding of innovation and competition in the financial sector. This submission draws heavily from the research conducted in the context of the FinTech market study.

Summary of recommendations

9. The submission provides a number of recommendations to Finance Canada regarding encouraging competition and innovation, reducing barriers to entry, and empowering Canadians to take advantage of competition in the marketplace. These recommendations are organized according to the questions posed by Finance Canada and can be grouped under five overarching themes. In summary:

    a. Regulation is imperative to address market failure but should be minimally intrusive on market forces, allowing competition to determine outcomes;

    b. Consumers[1] should be able to easily switch between service providers and Finance Canada should encourage leveraging technology to facilitate switching and information and data sharing;

    c. Regulation should be technology-neutral and device agnostic, principle-based rather than prescriptive, and based on the activity or function an entity is engaged in, rather than the type of entity;

    d. Regulation should be proportional to the actual risks associated with that activity or function; and

    e. Regulation should be harmonized and simplified to mitigate potentially overlapping and conflicting rules.

10. The Bureau is encouraged by Finance Canada's statement that "competition in the financial sector can be a tool to deliver economic growth". Competition drives efficiency, innovation, and ensures that consumers and businesses can continue to benefit from competitive prices, and product choice.

Supporting a competitive and innovative sector

11. Finance Canada is seeking views on how to prepare for the wave of innovation that new financial technology tools (FinTech) is expected to bring in the near term.

12. FinTech has the potential to reduce common frictions that consumers and businesses encounter when accessing financial services, to introduce new ways of accessing existing services, or in some cases, introducing new services altogether.

13. Several companies are entering the Canadian marketplace outside the framework for regulated financial institutions. While new entrants bring an important competitive and innovative dynamic to the marketplace, incumbent financial institutions may be somewhat limited by regulation to do the same with their own FinTech, reducing their competitiveness with new entrants.

[1] In this submission, the term "consumers" refers to all consumers of financial services—business and retail consumers.

14. As such, any modernization of rules regarding a financial institution's ability to develop their own innovative FinTech in-house could enhance the level of competition in the marketplace to the benefit of Canadians.

Collaboration

15. Finance Canada seeks views on whether to expand the opportunities for federally regulated financial institutions (FRFIs) to collaborate with FinTech entrants—including through non-controlling investment—subject to appropriate limitations.

16. The Bureau supports the expansion of flexibility for FRFIs to engage in innovative collaboration with FinTech entrants. Collaboration with new innovators can help bring new products to market sooner, and on a larger scale. Strategic alliances can permit Canadian firms to capture the benefits of rapid technological changes and dynamic competitive conditions. They can permit firms to combine capabilities and resources that may allow for lower costs of production, enhanced quality, and reduced time to bring new products to market. Caution is urged, however, as collaboration between competitors can lead to anti-competitive outcomes. Finance Canada should consider the potential impact of collaborations or partnerships on competition. The Bureau's *Competitor Collaboration Guidelines* and recent statement on the Government of Canada's Innovation Superclusters Initiative can provide guidance on collaboration between actual and potential competitors.

17. Further, regulators and policy-makers should continue their efforts to collaborate with industry on setting regulation and policy. It is imperative that industry-regulator collaboration include a diverse group of stakeholders, including consumer and business groups, incumbent financial institutions, challenger institutions (e.g., small and medium-sized banks and credit unions), and new entrants (e.g., FinTech entrants), such that policy does not create unnecessary regulatory moats around existing financial institutions.

Role of small and medium-sized banks

18. Finance Canada also seeks views on how to best ensure the financial sector supports long-term economic growth, including the role of small and medium-sized banks in enhancing innovative and competitive potential of the Canadian economy.

19. Small and medium-enterprises, including small and medium-sized banks, are key drivers of innovation as they set themselves apart from their larger competitors to attract customers.

20. The regulatory compliance burden on small and medium-sized banks is typically heavier, in proportion to their size, as compared to larger banks that enjoy greater scale economies for compliance. As such, the Bureau supports measures to reduce barriers to entry by ensuring that regulation is proportional to the associated risks of the activities an entity is carrying out.

Enhancing competition through open banking

21. Finance Canada has sought views on other measures, including open banking, to support competition and innovation.

22. A competitive marketplace requires, at a minimum, three core elements:

    a. The threat of entry must be credible (i.e., barriers to entry should be sufficiently low to ensure constant discipline of incumbent firms);

    b. The threat of customer losses due to switching must be credible (i.e., it must be easy for customers to switch between service providers, and customers must have access to price information and other measures of value); and

    c. The marketplace must have competitors (i.e., for either of the above to be credible, there must be substitutability in the marketplace).

23. To ensure that customers are able to exploit competition, they must have viable alternatives to their current financial service provider. They must also have the necessary information—for example with respect to prices and services offered—to make informed decisions.

24. Customers also need to be able to switch between competitors easily. To drive competition, financial services customers must have a credible threat to their incumbent service provider. This means that they must:

    a. Have an alternative service provider who can meet their needs at a competitive price; and

    b. Be able to easily switch to the alternative service providers.

25. The credible threat of switching pushes service providers to keep their prices low, or otherwise deliver increased value to their customers.

26. In order for the threat of switching to be credible, customers must have the means and ability to easily, and quickly, switch between service providers. In financial services, the process of switching is often complicated by several factors, including:

    a. Potential fees or penalties associated with closing accounts, cancelling products, or early termination;

    b. Difficulty in assessing and evaluating competitive options in terms of price, in particular when prices are opaque or change depending on usage and bundling;

    c. Difficulty in assessing and evaluating the quality of services from one service provider to another;

d. Ensuring that pre-authorized transactions are properly switched between institutions, and that a customer has sufficient float to cover in the event that errors occur; and

e. The process of open and closing accounts may require in-person contact (for example, to verify one's identity), which can slow down the process of switching.

27. Ultimately, the barriers to switching between institutions have been both lowered by technology (the ability to transfer funds through online banking, or shop around for the best account) and raised by technology (increased use of pre-authorized debits and credits further entrench incumbent institutions with their customers).

28. These barriers can lead to customer inertia where, even when competitive options arise, customers are unwilling to undertake the seemingly difficult task of comparison shopping and ultimately switching service providers.

29. Reducing these barriers to switching can help facilitate the entry and effectiveness of small and medium-sized competitors.

30. To this end, the idea of "open banking" and use of application programming interfaces to facilitate switching appears to be promising. Open banking can provide different avenues for entrepreneurs to develop new ways to help customers shop around and switch. For example, open banking could:

a. Allow for the creation of data-rich and dynamic price comparison tools to allow customers to quickly compare offers between service providers;

b. Allow for data-rich advice with respect to service providers using a customer's actual data to recommend competitive offers[2] or help with budgeting[3];

c. Facilitate switching by automating account transfers and pre-authorized payment and debit forwarding between accounts;

d. Improve mechanisms that provide customers with account portability between institutions to facilitate switching, for example, customers in Australia and the United Kingdom will have unique account numbers; and

e. Help to establish a framework for remote identity verification to facilitate switching.

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[2] By way of example, consider a consumer who uses 10 debits per month on their chequing account, but pays for 20 in their account package. Open banking could facilitate the use of their account history to find providers or account packages that better match their usage of only 10 debits, at a lower cost.

[3] Budgeting applications already exist, however, their data collection methods can leave bank customers at risk as they typically use "screen scraping" to collect account histories, which often violates cardholder agreements with banks.

31. A significant barrier for many customers switching is the fees and penalties they may incur in so doing. Finance Canada should consider a review of account switching and closure fees, penalties for termination of accounts, and other direct costs to bank customers that might deter switching. These fees can outweigh the benefits of switching in the short-term. Open banking could help provide transparency to these fees and penalties by using a customer's own account history to calculate direct costs to switch.

32. Ultimately, open banking has the potential to reduce many of the existing frictions that customers face when they try to exploit existing competition, and the Bureau commends Finance Canada for examining the matter.

Improving the protection of bank consumers

33. The Bureau promotes truth in advertising in the marketplace by discouraging deceptive business practices and by encouraging the provision of sufficient information to enable informed consumer choice.

34. The Financial Consumer Agency of Canada (FCAC) should be recognized for their efforts to protect consumers and to promote financial literacy to help Canadians better understand financial products, as well as conduct research to better understand Canadian consumer behaviours. Consumer education is key to fully realizing the benefits of greater competition.

35. The Bureau welcomes opportunities to collaborate with the FCAC and other partners to help promote a marketplace where competition thrives and consumers are protected from anticompetitive, misleading and deceptive practices.

Bank words

36. To make informed choices, consumers must be able to understand marketing materials presented to them. This includes using language that is easily and commonly understood; the use of jargon can cause confusion among consumers, leading to sub-optimal choices. Using similar language between competitors facilitates comparison of products and services, allowing consumers to ensure that they are measuring like for like when shopping around.

37. While prudentially-regulated non-bank deposit-taking institutions, such as credit unions, are not banks, the products and services they offer their members are very similar to those a bank offers its customers.

38. By relaxing the limitations on the use of bank words, competing service providers could be better able to highlight their offer to consumers using language that consumers understand.

39. As such, the Bureau supports relaxing the limitations on the use of bank words in appropriate circumstances. While Finance Canada is better positioned to determine what those circumstances are, the Bureau recommends looking to the nature of the activities undertaken by the institution (e.g., whether the service provider offers demand deposit accounts) and the protections afforded consumers (e.g., are deposits covered by federal or provincial deposit insurance, and are there adequate levels of consumer protection at the federal or provincial levels?).

40. Indeed, some institutions that are currently allowed to lawfully use bank words are less associated with financial services and banking than with other lines of business (e.g., Walmart Canada Bank [consumer goods] and Rogers Bank [telecommunication and radio-television services]).

Conclusion

41. With the rise of new technologies in the financial sector, there is an opportunity to provide a wider variety of services to consumers in a more competitive marketplace. By reducing barriers to entry and switching, consumers can benefit from a more competitive, efficient, and innovative marketplace. The Bureau is encouraged by Finance Canada's attention to competition in its review of the federal financial sector framework.

42. The Bureau and its staff remain open to collaborating further with Finance Canada and welcome further engagement on future policy development.