REGULATING ECONOMIC COMPETITION IN FINANCIAL SERVICES

CONCEPT PAPER

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Table of Contents

PURPOSE AND BASICS OF THE CONCEPT

PART 1. COMPETITION AND THE FINANCIAL SYSTEM

1.1 Introduction

1.2 Peculiarities of the financial system

1.3 Stability and competition in the financial system

PART 2. REGULARIZATION OF COMPETITION IN EUROPEAN UNION: COMPARISON WITH ARMENIA

2.1. Anti-competitive agreements and cartels

   2.1.1. Concept of anti-competitive agreements and signs specific to them

   2.1.2. Detection of anti-competitive agreements (cartels); “Leniency policy”

2.2. Abuse of dominant position

   2.2.1. Action to record abuse of dominant position by the business

2.3 Concentrations (mergers)

   2.3.1. Annual returns as criterion for declaration of concentration

2.4 Exceptions from economic competition rules

   2.4.1. Exemption applied to certain categories of research and development agreements

   2.4.2. Exemption applied to specialisation agreements
2.4.3. Exemptions applied to certain categories of agreements in the field of insurance

2.5 REGULARIZATION OF COMPETITION IN ARMENIA

PART 3. Recommendations

3.1 Concentrations

3.2 Anti-competitive agreements

3.3 Abuse of dominant position

3.4 Our recommendation as a short-term goal

3.5 Recommendations in a long-term perspective

Appendix
PURPOSE AND BASICS OF THE CONCEPT

Economic competition in the context of financial stability

Providing market participants with conditions for free economic competition is one of important prerequisites for maintaining stability and development of a financial market. Yet study of international experience reveals that competition in the financial field has always been considered with a certain amount of reservation, and applying competition rules to the field has long been a subject of severe regularization and restrictions. Under current crisis conditions there is debate whether competition is something desirable in the time of systemic crises since any problem faced by the financial market needs to be addressed in the light of financial system stability.

These circumstances, legislative developments in the financial field, and a number of problems emerged in the competitiveness aspect in the financial sector were impulses serious enough for the Central Bank of the Republic of Armenia to consider applying effective mechanisms that would have economic competition in place and get them regulated in the financial market.

Economic competition in the context of unified, risk-based and preventive supervision
The Central Bank is the authority responsible for maintaining stability of Armenia’s financial market. This function of maintaining financial stability has been prescribed by the law. The Central Bank will tackle any issue regarding both the financial sector and competitiveness aspect in the framework of an overall financial market while identifying their potential relations with specific issues in the financial system and issues in other sectors.

It should be noted that this practice is inherent in the Central Bank also in its capacity as regulator and supervisor of the Armenian financial sector.

Principles of supervision applied with regard to financial organizations are also important in the context of what peculiarities are in place in regularizing competition in the financial sector. Thus, the Central Bank acts as supervisor of the unified financial system and carries out risk-based and preventive supervision.

The risk-based supervision requires that the supervision of financial organizations be carried out in order to disclose and eliminate risks associated with and critical to the stability of the system. In this context, the Central Bank will also choose to respond to the developments in the competition field, highlighting the importance of the risks deriving therefrom.

It should be noted that the supervision policy which the Central Bank implements in the financial field, including the protection of free competition among financial organizations, is of a preventive nature rather than a punitive one. Stressing the importance of the role each financial organization plays in the overall financial system, the Central Bank knows that its supervisory authority is somewhat restricted and needs to consider the specificities of any particular organization. When applying a sanction, a supervisor must always take into account what kind of impact it is going to have on financial standing of the organization in question. Article 63 (4) of the Republic of Armenia Law on Banks and Banking contains a provision saying that the sum of the penalty should not bring the bank in a distressed financial condition.
Peculiarities in regularizing competition in the financial market

Further on, priorities of the financial market may differ considerably from other sectors of the economy. Thus, the Central Bank has announced that it encourages and supports company mergers and magnifications in the financial market. Here it is worth mentioning that the policies of the Central Bank and of the Commission on Protection of Economic Competition are substantially different. Provisions in the Armenian law regarding concentrations in the area of protection of economic competition, which the CPEC applies to financial organizations as well, provide for severe regularization, and this is detrimental to the business of financial organizations.

Recent developments in the Armenian financial market are attributable to legislative innovations introduced to the insurance sector. In particular, a mandatory insurance class new to the country necessitated considerations about protection of competition in the insurance sector. This is important in a sense that new compulsory insurance classes could yet be introduced to the sector. This could, in turn, serve a ground that would weaken insurance companies’ ability for free competition in the market.

Research in the competition area shows that competition in the financial market is available and regularized, taking into account the peculiarities of the financial market. Take, for example, Regulation 139/2004 on Mergers which establishes for banks and insurance companies peculiarities inherent in their sectors, in addition to general regularization aspects. These peculiarities include, in particular, a procedure for calculating annual turnover: the regulation and a guideline tailored for banks define the elements which would be used to calculate banks’ and insurance companies’ annual turnover, which would then be used to measure the share of the market.

In view of the circumstances described above, there arises a need to reshape and redefine the mechanisms that vest the Central Bank with authority to maintain financial stability. Moreover, legislative initiatives will need to be taken on and effective mechanisms need to be in place to make sure free competition in the
market is maintained. Incidentally, recent developments in international marketplace and developments in Armenia’s financial market and increased competition in various segments of the financial market need to be taken into consideration.

The pivotal role of the Central Bank in this matter is stressed especially in the face of risks and challenges that emerge in the time of financial crisis.

PART 1. COMPETITION AND THE FINANCIAL SYSTEM

1.1 Introduction

Maintaining an environment for free competition is one vital precondition of economic development for any country, and the area of financial services is not an exception either. To the consumer, free competition guarantees both the provision of quality service and a choice of provision of such service thus enhancing the level of quality and reducing costs. Besides, free competition compels service providers to think about making innovation all the time so that the service they are providing is more attractive and in demand.

There are two basic models for regularizing competition: the US model and the EU model. Though somehow different because of their historical development, both models are virtually aimed to the same target, i.e. protection of the rights of consumers, including but not limited to providing them with an opportunity to choose, a free movement of goods and services in the market economy, and enabling the competitors to have an equal access to the market. In the U.S.A. there are two institutions responsible for maintaining competition – the Federal Reserve and the Department of Justice, whereas in the European Union it is the EU Commission that is responsible for competitiveness throughout the EU.

Generally, regularization of competition is supposed to bring about the following two directions: i) prevent any market participants from practicing market abuse and ii) prevent market participants from making such agreements
(covenants) between them which would restrict the free trade or provision of services.

These directions provide the basis on which the pillars of regularization of competition, including at the EU level, were erected.

1.2 Peculiarities of the financial system

The currently accepted theory of regularization of competition and its enforcement practices [in both the EU and the U.S.A. and at all regional levels] call for the need of having specific principles and rules for regularizing competition in the field of financial services.

It is known that financial organizations (especially those ones that attract deposits) are distinctive in terms of their degree of vulnerability to stability. What is more, people’s assets in the form of deposit are kept with banks. In the banking sector, the instability may emerge from:

- liabilities segment, which in turn is susceptible to the depositor reclaim and systemic crises, and
- banks’ assets segment.

Primarily, there are two types of depositor reclaim, which derives from:

- fear,
- main business/operations.

Fear appears when depositors lose their confidence in the bank and start taking deposits out of the bank regardless of their need for consumption at the moment.

Depositor reclaim deriving from the main business occurs when the bank seems to perform poorly. For example, depositors of the bank will have a foreboding of financial troubles and claim their deposits back when there are low loan
recoverability rates recorded with that bank.

Conventional wisdom and applied policies in general support the argument that the principal anxiety with bank failures is associated with the risk of contagion. The essence is that the failure of one bank or the dissemination of information about such failure will lead to the failure of some other financial companies because banks are linked to each other through different payment systems and because they operate in the interbank market.

Two different contagion mechanisms are possible:

- Risk of contagion, which derives from direct links between banks in the interbank market or from payment systems,
- Risk of contagion, which derives from indirect balance sheet relations between banks that are a result of affiliations of their portfolios.

The first source of the risk is lower when banks are better and more evenly affiliated since one bank’s loss in the portfolio will be transferred to the other banks’ through interbank contracts.

The second source of contagion derives from indirect balance sheet relations between banks, because of affiliations of their portfolios. When a bank has to allocate its portfolio or sell some of its assets in response to the financial shock, the portfolios of other banks are being affected as well. This could lead to a systemic crisis as a result of, say, a change in the price of assets.

This is to say that, unlike other fields of services where a participant’s failure creates new opportunities for its competitors, a financial organization’s failure could bring in problems of systemic nature.

In the Armenian financial sector too, a number of practical issues addressed in exercising the right of competition and the imperative of making certain services in the financial field mandatory from a legal or practical point of view (this refers to a mandatory auto insurance scheme) also prompted to develop this concept.
1.3 Stability and competition in the financial system

Competition in the financial field has always been considered with a certain amount of reservation, and applying competition rules to the field has long been a subject of severe regularization and restrictions. While in the last twenty years or so the competition policy has been relatively effective in the financial field, the present crisis again points to the role the competition policy has in the field. Questions are posed whether competition is desirable at all in the times of systemic crises and how to confine its adverse effects in the medium and long-run.

The competition policy has always been carried out in the banking sector with reasonable care. In the U.S.A. in the banking sector, for example, the anti-competitive law has not been applicable until 1963-1964: Up until now, financial organizations were treated differently in respect of the competition policy when compared to the organizations functioning in other areas.

In Europe, the Commission did not apply Articles 85 and 86 of the Rome Convention on Fair Competition to the financial field until the Zuchner case in the early 1980s, since at that time too the banking sector was considered to be a specific area. Banking business was subject to a great influence coming from monetary and financial policies implemented by competent authorities (central banks and financial sector supervisors, in particular) of Member States, other than to the influence from bodies responsible for competitiveness policies.

Current debates again lead to a conclusion that applying a competition policy to the field of financial services is once again a matter for discussion. There is even an argument that says to suspend applying the competition policy in the time of financial crisis. Moreover, prior to the crisis, back in 2002 it was already possible to consider a full removal of financial organizations from the scope of application of the anti-competitive law, taking into account the need to maintain financial stability of the financial system and the ‘specific nature’ of the sector.

As some official reports viewed, the current crisis was triggered by strong competition in the banking business, under which circumstance financial...
organizations were urged to bring in innovations all the time while taking unjustified risks as a result, in order to be more successful than their competitors.

Notwithstanding the peculiarities of the financial system and the above-described debates, the general rule of competition is that the anti-competitive law is to apply to all participants across all markets.

However, in certain other areas where public policy and/or public interest presume higher priorities then one needs to at least clarify:

- to what extent should regularization of competition be subject to such higher priorities, and
- what its lawful and reasonable justification should be like.

A government’s policy in the area of financial services will be aimed to the following main targets:

- Maintain stability and safety of the financial system, and
- Make sure provision of financial services is done at a proper level.

To achieve these goals, there are two main tools to use:

- Prudential supervision, which should be carried out to prevent financial organizations from taking unjustified risks,
- Regularization of competition, which is aimed to motivate rival financial organizations to improve the quality of financial services they provide, to reduce costs, to introduce innovations thus making their role of ‘economy financing’ more effective and further contributing to the economic growth.

As regards potential adverse effects of free competition, the regulation and supervision (prudential supervision) of the financial system is then supposed to be utmost inter-related and complementing, so that risks, which financial organizations will possibly take as a result of competition, are more balanced by dint of supervision and regulation.

PART 2. REGULARIZATION OF COMPETITION IN EUROPEAN UNION:
COMPARISON WITH ARMENIA

The EU core competitiveness rules which are prescribed as Articles 101 and 102 of the EU Treaty apply to all sectors of the economy, including the field of provision of financial services. At the same time, peculiarities of the field of provision of financial services must be considered when establishing particular procedures and guidelines on implementation of general rules.

The EU competition law consists of 4 pillars:

- Anti-competitive agreements and cartels (Article 101),
- Market/domination abuse (Article 102),
- Concentrations, mergers (Regulation on Mergers 139/2004)
- Public support (Articles 106, 107):

2.1. Anti-competitive agreements and cartels

2.1.1. Concept of anti-competitive agreements and signs specific to them

Article 101 (1) and (2) of the EU Treaty prohibits all agreements between undertakings, decisions by associations of undertakings and concerted practices which have as their object or effect the prevention, restriction or distortion of competition within the internal market, and in particular those which:

- directly or indirectly fix purchase or selling prices or any other trading conditions,
- limit or control production, markets, technical development, or investment,
- share markets or sources of supply,
- apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage,
- make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to
commercial usage, have no connection with the subject of such contracts.

Of the anti-competitive agreements, the heaviest impact comes from cartels, so there is stricter responsibility defined in respect of the participants of such cartels.

A cartel as well as any other anti-competitive agreement is virtually an arrangement between the parties which they conclude with the aim not to compete with each other, yet in this case they need to be direct competitors, i.e. they need to operate in the same product market, provide the same services, and so on.

Anti-competitive agreements which are concluded between the parties who are not direct competitors but who interact on the same area of business (an example is the relations between the producer and the supplier; the supplier and the vendor) are not considered as cartel. Incidentally, such anti-competitive agreements can be concluded for a purpose other than the infringement of competition but when competition law is violated however.

To a free competition, more ‘harmful’ are the anti-competitive agreements, the purpose of which is:

- price fixing,
- market sharing – regional or consumer group distinction in the market, which can also result in restricted access to the market,
- product restriction – control over the product or services in order to keep prices high in the market.

The price fixing agreements (cartels) can be aimed to different targets. In particular, the participants to such agreements (cartels) may agree upon discounts, limitations, price increases or minimal prices.

The warning signs of price fixing are:

- exchange of confidential or vital information between the participants,
- any warning sign that two or more vendors have agreed to use the same pricing or discounting for their product,
- price of identical products changes at a number of vendors,
price changes take place on a regular and uniform basis,
identical explanations are given in connection with price changes,
The warning signs of market sharing are:
any warning sign that two or more vendors of the same product have agreed to not sell the product to the rival’s clients,
any statement that the particular territory is not the rival’s territory, and etc.

2.1.2. Detection of anti-competitive agreements (cartels); Leniency policy

Detecting anti-competitive agreements (cartels) is intricate and difficult to do while outcome and results are often not trusted. Until now most cartels have been detected due to complaints and the usage of the ‘leniency’ policy, which is an important achievement in the field of fight against anti-competitive agreements in recent years. This was first practiced in the U.S.A. and afterwards was commonplace in the EU states.

The leniency policy encourages the participant to the anti-competitive agreement to admit its involvement with such agreement and to disclose its partners by providing direct evidence on unlawful activities in exchange of the opportunity to get released from liability.

There are countries that now develop various programs on the leniency policy which can be attractive to the participants to the anti-competitive agreements. In this regard, it is important that uniform and strict sanctions be in place for anti-competitive agreements and cartels in particular, so that the participants to anti-competitive agreements get interested in benefiting from the opportunity the leniency policy provides.

In the EU, the detection of cartels is the Commission’s responsibility. More on that, detecting cartels through carrying out inspections is very important. Carrying out unexpected inspections is an effective method to obtain necessary data and holding cartels liable. Legal ground on which such inspections are
carried out is established under Commission Regulation 1/2003 which defines the procedure of inspections, inspector’s competence and so on.

Normally, inspections are launched when a particular amount of information is at hand; the following may be a source of such information:

- information which participants to the anti-competitive agreement and/or cartel make available in the framework of the leniency policy,
- information which former employees of the company as party to the anti-competitive agreement make available,
- information provided by competitors and consumers even if it is not clear enough and sufficient, and etc.

8.2. Abuse of dominant position

Article 102 of the EU Treaty prohibits any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it in so far as it may affect trade between Member States.

Such abuse may consist in:

- directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions,
- limiting production, markets or technical development to the prejudice of consumers,
- applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage,
- making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.
2.2.1 Action to record abuse of dominant position by the business

The following action shall be taken to record the abuse of dominant position by the business:

- determination of a relevant product market,
- assessment of the dominant position the business has in the competent market (e.g. has a monopoly, a significant monopolistic power in the market),
- illegal action taken by the business which has a dominant position (a monopoly, a significant market impact).

In order to record the abuse of dominant position, a relevant market (product market and geographic market) needs to be determined first.

The EU Commission has adopted a guideline which contains the definition of both product and geographic markets. Not only the guideline provides clear criteria on how to determine the product market but it also sets the goals for determining the product market, at a policy level. The guideline gives a detailed methodology on how to determine a relevant product market, which criteria such determination should be based on, what action should be taken, and so on. The guideline addresses the issue of determining the primary and secondary product markets, i.e. the products which are not substitutes but rather are affiliated.

Incidentally, determining a product market is also important in order to know the number of market participants, which is itself an important factor in ascertaining the fact of dominant position in the market.

Once the product market is determined, the position the business takes in the market should be evaluated according to the factors, as follows:

A. Share a business has in the market
Determining the share in the market is a key factor in defining the dominant position the business has in the market. Normally, there are limitations covered by legislations, and any shares equivalent to or in excess of the established thresholds will serve a ground to ascertain the fact of dominance the business has in the market.

Note that different limitations are conditional on the different structures and peculiarities that exist in product markets.

There are formulas used in calculating the market share. For example, ‘The Methodology for Assessment of Market Share of the Business’ shall be used to determine how much dominance the relevant business has in the particular market. Where banks and non-banks are involved, their accounting balance sheets will be used as a basis for calculation; where insurance companies are involved, the total amount of insurance cover will be used:

The market share shall also be calculated for investment brokers by using the total value and number of transactions concluded, the number of advisory service, the number of investment portfolios managed, the number of securities issued. Where investment firms are involved, the market share shall be calculated by using the number of investment they made.

B. Conditions for market entry

For ascertaining the fact of dominant position in the market, it is important to determine whether there are legal and/or economic impediments that prevent or restrict others’ entry to the market:

- considerable capital investment
- timing necessary for entry to the market
- a relevant licensing mechanism in place
- restrictions arising from taxation, pricing, lending.
C. Limits of impact the business has in the market

The impact the business has in the market presumes its ability to set prices, eliminate competition and act independently from other competitors, consumers and clients.

When evaluating the impact in the market, the following factors should be taken into account:

- Yield
- Marketability of the services provided
- Financial independence.

When evaluating the dominant position in the market, the demonstration by the business of a behaviour which is prohibited by the law is very important, too. The law normally specifies the behaviour which is considered to be violating or restrictive with regard to free economic competition.

It is commonly acknowledged that the fact of the abuse of dominant position in the market is attributable to the significant power and/or impact the business has in that market.

In implementation of constituent covenants as well as other EU acts that regularize competition, Member States normally adopt guidelines which provide for a detailed procedure and methodology for determination of dominant position and assessment of abuse of dominant position. In addition to the above mentioned elements required for assessing the dominant position and its abuse, these guidelines address such matters as the collective dominant position or collective abuse of dominant position, the buyer’s impact on the position of the parties competing with each other on the market, and etc.

And, finally, when talking about the abuse of dominant position, one should take a note that the abuse can happen not where the person takes a dominant position but rather elsewhere, in the market which is closely affiliated therewith.
2.3 Concentrations (mergers)

At the EU level, concentrations are regularized under the Council Regulation 139/2004 regarding the control of company concentrations.

The Treaty establishes the concept of concentrations and it sets the limits within which the concentration will be seen, firstly, at a community level and, secondly, will be subject to declaration.

2.3.1 Annual returns as criterion for declaration of concentration

The study of the EU and EU Member States’ experience shows that determining the threshold for declaration of concentrations is only based on annual returns. Specifically, Article 5 of Regulation on mergers provides for the methodology on calculation of returns.

Total return involves the sums received from the sale of goods and provision of services by the company during the previous financial year, deducted by sales discounts, VAT and other taxes which are directly related to the return.

The regulation provides a methodology for calculation of return of financial organizations.

Specifically, return of banks and other financial organizations shall be calculated as follows:

- Income on interest and such other income, income on securities,
- Income on shares of affiliated companies,
- Net income on financial operations, and etc.

In terms of determining concentrations, the U.S.A. experience is worthwhile to consider as well. In the U.S.A. concentrations are determined by means of the Herfindahl–Hirschman Index, HHI. The index is broadly used in the competition law to calculate concentration in the market and to calculate and assess competition among companies.
For calculation, one needs to:

- determine the number of companies available in the market,
- evaluate each company’s market share, which means the company’s sales in the market divided by total sales in that market,
- calculate the square of each company’s market share,
- add the squares of all companies’ market shares, which comes as the HHI.

In the USA, the U.S. Department of Justice identifies 3 levels of market concentration and determines the issue of company mergers accordingly

- **Non-concentrated** when in the market the HHI is below 1000: in this case the company merger is not problematical,
- **Moderately concentrated** when in the market the HHI is in the range of 1000-1800: in this case the U.S. Department of Justice will examine what anti-competitive effects would the merger bring in with,
- **Highly concentrated** when in the market the HHI is above 1800: in this case each transaction in highly concentrated market which adds the HHI with more than 100 points can be seen as a serious anti-competitive impulse.

### 2.4 Exceptions from economic competition rules

As we stated earlier, the enforcement of provisions of competition rights in the financial field should be considered in the light of financial stability. This is why one needs to define cases which albeit fit by their features the behaviour on restricting anti-competitive agreements or otherwise competition they however fall within the exceptions for enforcement of provisions of competition rights. This idea lies in the EU competition law (Article 101 (3) of the Treaty).

The exceptions from the enforcement of provisions of competition rights
are ‘justified’ when there is higher priority of public interest, e.g. stability and development of the financial system.

For example, one may argue that higher priority of public interest is an existing strong competitive market: the market will develop if there is free and strong competition (this is more typical to the U.S. model of regularization of competition).

The EU also sees the sustainable and safe market and development of services as higher priority of public interest.

In this sense, defining exceptions from the enforcement of competition rules can be acceptable due to the following circumstances:

- often, in the financial stability point of view, it is more advisable that financial organizations spend their efforts not to compete with each other but rather act in concert, in order to develop the market. It is obvious that when higher priority is not a consideration we may then talk about the anti-competitive agreement, or
- sometimes acquisition by one company of another one can be allowed if that is aimed to an improved quality of services and/or products or to see the system more sustainable, or
- concerted action and partnership, including agreements concluded between financial organizations with the goal to bring new products and services in to the market will sometimes be not considered as infringement of the rules of free competition, again in consideration of the primary concern of maintaining sustainable development of the market and/or the system.

The area of exceptions from the behaviour that restricts competition within the EU is thoroughly regularized, e.g. a number of regulations were adopted to automatically allow ‘research and development’ agreements and specialization agreements, the application of Article 101 (3) of the Treaty to the agreements in the insurance sector, as well as a number of guidelines were adopted, with the
To apply the exemption, the following test shall be exercised:

- First off, it is estimated whether there is behavior in place, a contract signed between the companies which could have a purpose of infringing the competition or restrict the competition at present or in future, if yes,
- It is determined whether there are 4 conditions in place that are applied to exceptions:
  - behaviour or agreement should contribute to the manufacture and supply of the product (services) or contribute to the technical or economic progress.
  - restrictions are mandatory in order to achieve those results,
  - consumers should benefit from such behaviour and agreements, i.e. the benefits of the parties alone are not enough to justify competition restrictions,
  - behaviour and agreement should not allow the parties an opportunity to eliminate the competition in the particular product market.

Incidentally, the obligation of proving the existence of the above-described circumstances necessary for applying the exemption from the competition rules rests with the companies.

2.4.1. Exemption applied to certain categories of research and development agreements

Research and development agreements are the agreements that can be concluded in any sector of the economy and, particularly, in the field of financial services.

Joint implementation of research work as well as joint exploitation of the results of research are normally exempt from the enforcement of the anti-competition rules (Article (101(1)), if these are in line with the exceptions provided for under Article 101(3). Anyway, it should be decided whether these agreements
are capable to produce favourable results to the consumer as well, allowing the latter to benefit novice or more advanced services or products on the one hand and more affordable prices decreased as a result of research and development. The EU Regulation determines the limitation of market share of the parties to the agreement. In the event of joint research and development agreements the value of market share of the parties should not exceed 25%. The above-referred exemption shall be applicable to such agreements so far as the said limitation [25 %] has not been increased.

2.4.2. Exemption applied to specialisation agreements

The specialisation agreements may also be commonly used for financial organizations. Exemption applied to them enables to ease administrative control. The specialisation agreements contribute to the improvement of quality of products and services. Parties professionally active in one area or another are able to carry out production of goods and provision of services more effectively. Accordingly, they are able to set a lower price which is ultimately beneficial to the consumer, too.

Specialisation agreements fall into 3 groups:

- **Unilateral specialisation agreement** means an agreement between two parties which are active on the same product market by virtue of which one party agrees to fully or partly cease production of certain products or to refrain from producing those products and to purchase them from the other party, who agrees to produce and supply those products,

- **Reciprocal specialisation agreement** means an agreement between two or more parties which are active on the same product market, by virtue of which two or more parties on a reciprocal basis agree to fully or partly cease or refrain from producing certain but different products
and to purchase these products from the other parties, who agree to produce and supply them,

- **Joint production agreement** means an agreement by virtue of which two or more parties agree to produce certain products jointly.

The exemption to specialisation agreements shall apply on condition that the combined market share of the parties does not exceed 20 % on any relevant market. The market share shall be calculated on the basis of the market sales value; if market sales value data are not available, estimates can be based on other reliable market information.

Where an established threshold exceeds 20 % but is below 25 %, the exemption to anti-competition rules shall be applied for another 2-year term; where the threshold exceeds 25 %, the exemption shall be applied for the next 1-year term only.

The exemption shall not apply when the specialisation agreements are directly or indirectly aimed at:

- price fixing,
- output or sales restriction,
- market or consumer allocation.

### 2.4.3. Exemptions applied to certain categories of agreements in the field of insurance

At the EU level, there is differentiated approach only with regard to certain categories of agreements for insurance companies, out of financial organizations, in order to apply exemptions. The provisions of competition rights shall uniformly be applied to other sectors, the banking sector in particular.

The Treaty establishes the share each company in the insurance and coinsurance companies’ pools has in that particular product market and the basis for calculation of that share, using such indicators as *gross premium income*, *insured risk value*, and etc.
The Treaty provides for applying exemptions to a number of agreements in the insurance sector. It specifically is applied to the agreements concluded between two or more companies in the insurance sector, which relate to:

- **the exchange of statistical information necessary for calculation of risks**
- **joint coverage of certain types of risks.**

The exchange of information for calculation of risks relates to the calculation of price of coverage of certain risks previously, the unification of statistical information and compilation of information tables as well as the implementation of joint studies of results and distribution of results.

The Treaty clearly defines terms for applying exemption. Specifically, the exemption provided for in Article 2 (a) of the Treaty shall apply on condition that the compilations or tables:

- are based on the assembly of data and are capable to provide statistical information concerning:
  - the number of claims during the said period,
  - the number of individual risks insured in each risk year of the chosen observation period,
  - the total amounts paid or payable in respect of claims that have arisen during the said period,
  - the total amount of capital insured for each risk year during the chosen observation period,
  - include as detailed a breakdown of the available statistics as is actuarially adequate,
  - do not include in any way elements for contingencies, income deriving from reserves, administrative or commercial costs or fiscal or parafiscal contributions, and take into account neither revenues from investments
nor anticipated profits.

Unified data, tables and results of the study shall:

- not identify the insurance company concerned or any insured party,
- include a statement that they are non-binding,
- not contain any indication of the level of commercial premiums,
- be made available to any insurance company which requests a copy of them,
- be made available to consumer organisations on condition that such information is not disclosed.

**Common coverage of certain types of risks**

As mentioned earlier, the Treaty shall not apply to agreements entered into between two or more undertakings in the insurance sector with respect to the setting-up and operation of pools of insurance undertakings or of insurance undertakings and reinsurance undertakings for the common coverage of a specific category of risks in the form of co-insurance or co-reinsurance.

The Treaty establishes an interesting mechanism whereby the exemption is applicable for a three-year period upon creation of any co-insurance or co-reinsurance pool for a purpose to cover new risks.

As concerns co-insurance or co-reinsurance pools which are not specifically to cover new risks, the exemption shall apply as long as the Regulation remains in force, on condition that the combined market share held by the participating undertakings does not exceed:

- in the case of co-insurance pools, 20 % of any relevant market,
- in the case of co-reinsurance pools, 25 % of any relevant market.

The exemption shall apply on condition that:

- each participating undertaking having given a reasonable period of notice has the right to withdraw from the pool, without incurring any sanctions,
the rules of the pool do not oblige any participating undertaking of the pool to insure or reinsure through the pool,

the rules of the pool do not restrict the activity of the pool or its participating undertakings to the insurance or reinsurance of risks located in any particular geographical part,

the agreement does not limit output or sales,

the agreement does not allocate markets or customers,

the participating undertakings of a co-reinsurance pool do not agree on the commercial premiums which they charge for direct insurance.

2.5 REGULARIZATION OF COMPETITION IN ARMENIA

In Armenia there is a suit of laws that contain provisions regarding regularization of competition in the field of financial services.

First off, Article 35 of the Republic of Armenia Law on the Central Bank establishes the Central Bank’s commitment to creating conditions for free competition in the financial sector by taking up action as required by the law.

Some articles in such laws as on Banks and Banking, Insurance and Insurance Activity, and Credit Organizations establish a prohibition over anti-competitive agreements and concluding of transactions leading to dominant positions by banks, insurance companies and credit organizations. In particular:

- **Article 42 of the law on Banks and Banking** prohibits banks to enter into such transactions which are directed or lead to the restriction of free economic competition among banks, or which cause the bank, any person affiliated or cooperating therewith obtain a dominant position in the Armenian banking market thus enabling them to foreordain terms and conditions of financial operations or even of a single financial operation.

- **Article 83 of the law on Insurance and Insurance Activity** prohibits
insurance companies to enter into such transactions which are directed or lead to the restriction of free economic competition in the insurance market, or which cause the insurance company, any person affiliated or cooperating therewith obtain a dominant position in the Armenian insurance market thus enabling them to foreordain insurance market terms and conditions. Further, the law has Article 126 (2) 5 that establishes that the Central Bank shall decline the request for transfer of an insurance portfolio if that would lead to the restriction of economic competition.

- **Article 22.2 (5) ‘d’ of the law on Credit Organizations** says that the Central Bank may decide not to give consent to the letter requesting a change of the type of credit organization activity if such action is directed, leads or may lead to the restriction of free economic competition.

Some other articles in these laws contain a reference to concentrations [in terms of mergers and qualifying holdings] by only providing the definition thereof. In particular:

- **Article 18 (2) ‘f’ and ‘g’ of the law on Banks and Banking** prompts the Central Bank to decline a preliminary consent to the request for obtaining qualifying holding in the statutory fund of the bank if that transaction is directed or leads or may lead to the restriction of free economic competition, or if that transaction helps the person (and persons affiliated therewith) obtaining qualifying holding in the statutory fund of the bank to take a dominant position in the Armenian banking market thus enabling them to foreordain terms and conditions of financial operations or even of a single financial operation.

- **Article 68 (4) 5 of the law on Banks and Banking** establishes that the Board of the Central Bank may decide not to give consent to the agreement on a bank merger if that would enable the bank to obtain a dominant or monopolistic position in the banking market.

- **Article 18 (1) 5 of the law on Insurance and Insurance Activity** establishes that the Board of the Central Bank may decline a preliminary consent to the request for obtaining qualifying holding in the statutory fund
of the insurance company if that transaction is directed or leads or may lead to the restriction of free economic competition. **Article 130 (4) 4** of the same law says that the Board of the Central Bank may decide not to give consent to the company if the Central Bank believes that the surviving company or the party or the parties affiliated thereto with a qualifying holding in the statutory capital of the company will acquire a dominant position in insurance market.

- **Article 10 (2) ‘e’ of the law on Credit Organizations** also provides the Central Bank with the capacity to decline the request for qualifying holding if that transaction is directed, leads or may lead to the restriction of free economic competition.

As a matter of fact, neither laws and regulations nor legal acts and Central Bank resolutions establish a procedure and methodology for enforcement of authority by the Central Bank in the manner as described in general EC regulation on competition.

The Armenian legislation does not refer to the exception to the application of competition rules, which were presented in part 2.4 of this paper.

In Armenia, competition is also regularized under the Republic of Armenia Law on Protection of Economic Competition as well as some decisions adopted by the State Commission on Protection of Economic Competition concerning product markets, concentration rates, dominant positions and abuse of dominant positions. Such regularization has its drawbacks, as follows:

- regularization and definitions are of a general nature and they do not take into account the peculiarities of the financial sector, e.g. concentration rates, product markets, participants’ share in the market, among others,
- in many cases the peculiarities as established under the EU acts, guidelines, recommendations or decision of the European Court of Justice were not taken into account. For instance:
  - when determining a relevant geographic market, it is important that the terms of competition in that particular geographic region, i.e. market condition, number of participants and etc. be identical and vary from
the condition established elsewhere,

- regularization does not cover the issue of the secondary product market,
- the buyer’s impact on the market is not addressed in connection with dominant position or abuse of dominant position,
- the cases of collective dominant position or collective abuse of dominant position are not addressed,
- exceptions to the application of competition rules are not established, and so on.

- Even where regularizations are in place, these are of a general nature, which means a detailed methodology on, say, elements necessary for determining the product market, the assessment and establishment of criteria for each of these elements is missing.
PART 3. Recommendations

It makes obvious from what was described above that legal regularization of competition in the financial sector cannot be considered adequate from best international experience point of view.

There are only a few provisions concerning regularization of competition contained in some laws which are provided chiefly in the form of definitions. Under such a circumstance, though the financial system regulator has a unit in charge of dealing with competition issues, it still lacks an adequate legal framework in order to carry out effective regularization which complies with best international experience and, particularly, the EU criteria.

Considering that regularization of competition is believed to be a vital instrument in the hands of the financial system regulator for maintaining the financial stability, below we present recommendations on creation of a respective legal framework which would allow to handle regularization of competition in compliance with best international experience and the EU criteria, in particular.

The proposed legal acts due to be endorsed are presented as pillars of regularization of competition, i.e. anti-competitive agreements, abuse of dominant position, concentrations. The recommendations include long- and short-term perspectives, as follows:

- **long-term**, which are possible to implement by making changes to the law;
- **short-term**, which are possible to implement within the scope of authority vested with the Central Bank under applicable law, and which may be included in nearest workplans of respective units of the Central Bank.

### 3.1 Concentrations

Above we referred to the provisions of the financial laws that empower the
financial system regulator to regularize concentrations of financial organizations when considering and allowing and/or approving their requests for obtaining qualifying holding and mergers.

As a short-term goal, our recommendation is to adopt:

<table>
<thead>
<tr>
<th>Legal act</th>
<th>Written authority</th>
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<tbody>
<tr>
<td>For financial organizations, establish the purpose of declaration of concentration, the limits and the method how to determine the limits, by taking the financial organizations’ annual turnover figures as a benchmark.</td>
<td>Law on Banks and Banking, Article 18 (2) ‘f’ and ‘g’; Article 68 (4) 5;</td>
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<td>Law on Insurance and Insurance Activity, Article 18 (1) 6; Article 130 (4) 4;</td>
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<td>Law on Credit Organizations, Article 10 (2) ‘e’;</td>
</tr>
<tr>
<td>Develop a procedure on declaration of concentrations by financial organizations with the Central Bank.</td>
<td>Law on Banks and Banking, Article 18 (2) ‘f’ and ‘g’; Article 68 (4) 5;</td>
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<tr>
<td></td>
<td>Law on Insurance and Insurance Activity, Article 18 (1) 5;</td>
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<td>Law on Credit Organizations, Article 10 (2) ‘e’.</td>
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</table>

### 3.2 Anti-competitive agreements

In view of the provisions in financial laws that prohibit financial organizations to enter into anti-competitive transactions and agreements, as a short-term goal we recommend to adopt as follows:

<table>
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<th>Legal act</th>
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<tbody>
<tr>
<td></td>
<td>Law on Banks and Banking, Article 18 (2) ‘f’ and ‘g’; Article 68 (4) 5;</td>
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<td></td>
<td>Law on Insurance and Insurance Activity, Article 18 (1) 5;</td>
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<td>Law on Credit Organizations, Article 10 (2) ‘e’.</td>
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</tbody>
</table>
A regulation (under a Central Bank resolution) on anti-competitive agreements in order to establish:

- definition of anti-competitive agreements and the types thereof;
- impulses to detect anti-competitive agreements; sources of getting information;
- action, including supervisory tools, required to detect anti-competitive agreements;
- criteria and rules which define an agreement to qualify as anti-competitive;
- a method to determine the share of participants of anti-competitive agreements in the market;
- a leniency policy, its main principles and enforcement.

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<thead>
<tr>
<th>Legal act</th>
<th>Written authority</th>
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<tbody>
<tr>
<td>Law on Banks and Banking, Article 42;</td>
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<tr>
<td>Law on Insurance and Insurance Activity, Article 83;</td>
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<tr>
<td>Law on Credit Organizations, Article 22.2 (5) ‘d’.</td>
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</tbody>
</table>

### 3.3 Abuse of dominant position

As a short-term goal we recommend to adopt the following:
A procedure that defines what a dominant position is and what an abuse of dominant position is; it will specifically describe:

- goals of a particular product market and determination of a dominant position, at a policy level;
- rules and methodology for determination of product market and geographic market, taking into account the peculiarities of the field of financial services;
- criteria and rules which will be used to determine whether financial organization has a dominant position in the market;
- criteria and rules which will be used to determine whether financial organization abuses the dominant position;
- criteria and rules which will be used to measure the market share of the dominant person.

| Law on Banks and Banking, Article 42; |
| Law on Insurance and Insurance Activity, Article 83; |
| Law on Credit Organizations, Article 22.2 (5) ‘d’. |

### 3.4 As a short-term goal, our recommendation is also to adopt:

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<th>Legal act</th>
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A regulation (under a Central Bank resolution) on applying exceptions to the competition rules, which will determine, specifically:

- the reason and purpose for applying exceptions to the competition rules, at a policy level;
- which agreements, transactions and cases such exceptions will apply to;
- which terms and criteria will be required for applying the exceptions; how these will be determined, at a methodology level.

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Reasoning</th>
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<tbody>
<tr>
<td>Set, under the law, an objective for regularization of competition in the field of financial services, at a policy level.</td>
<td>In the financial field, regularization of competition needs to be considered in the light of priority of financial system stability, which will, in turn, be prescribed in the law as a policy.</td>
</tr>
<tr>
<td>Establish, under the law, that it is the financial system regulator’s responsibility to regularize competition in the field of financial services, and to determine the scope of the regulator’s authority.</td>
<td>In the financial field, regularization of competition is virtually one of the instruments used to maintain sustainability and well-functioning of the financial system. In this sense, the law needs to give a detailed description as to the financial system regulator’s competence in regularizing the competition in the field of financial services.</td>
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3.5 *Recommendations in a long-term perspective*

Our long-term recommendations are as follows:

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Reasoning</th>
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<tr>
<td>Set, under the law, an objective for regularization of competition in the field of financial services, at a policy level.</td>
<td>In the financial field, regularization of competition needs to be considered in the light of priority of financial system stability, which will, in turn, be prescribed in the law as a policy.</td>
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<td>Establish, under the law, that it is the financial system regulator’s responsibility to regularize competition in the field of financial services, and to determine the scope of the regulator’s authority.</td>
<td>In the financial field, regularization of competition is virtually one of the instruments used to maintain sustainability and well-functioning of the financial system. In this sense, the law needs to give a detailed description as to the financial system regulator’s competence in regularizing the competition in the field of financial services.</td>
</tr>
</tbody>
</table>
In financial laws, have the aspect of competition regularized according to such pillars as anti-competitive agreements, abuse of dominant position, concentrations;

Have the law to establish main principles and rules for regularization of each of those pillars.

Have the law to establish cases of exceptions to the applying of competition rules.

Financial laws, regularization of competition do not comply with pillars of regularization of competition so accepted in theory and practice. Therefore, their definitions as well as main principles are not differentiated, so this needs to be addressed in the law as a long-term goal.

Establishing exceptions, under the law, to applying competition rules, and developing the main guidelines on how these are used, will be reasonable in a long-term perspective.

Appendix 1

Practical competition issues in Armenia

Participants of the Armenian financial market have repeatedly faced with a dilemma which derives unclear distinction of competences of the Central Bank of Armenia and the Commission. This has brought in situations when measures taken up were lawful and acceptable from the financial law point of view yet they provided a ground which led to liability under the law on protection of economic competition. Specifically:

- In 2009 a foreign bank acquired 51 percent of shares of a bank operating in Armenia, and this was considered a prospective investment in the country’s financial market in terms of its development and future progress. To the Commission, however, this was a case of concentration under Article 9 of the Republic of Armenia Law on
Protection of Economic Competition and therefore a subject of declaration under the law.

- In 2011 the Commission instituted an administrative proceeding against HayBusinessBank CJSC, alleging the Bank in a possible violation of the law, i.e. taking a dominant position in the market. The story involves a loan contract signed between the Bank and “Getamech” Ltd, a pig breeder. The contract was secured by a pledge in the form of shares of “Elshinnakhagits” Ltd, an electric works designer. The Bank acquired 100 percent of the shares of “Elshinnakhagits” Ltd as a result of non-fulfillment of the loan obligation.

In the latter case though we are talking about a lending business of the bank, since the law allows the bank to provide loans to both legal persons and individuals, in which case the pledge, as defined in the Republic of Armenian Civil Code, is the security for fulfilling the loan obligation. This case reveals that no classic acquisition of the share took place but rather the shares were transferred as a result of the respective party’s failure to meet its loan obligation.

It should be noted that the financial market participants face with serious difficulties in the administrative point of view, too, as they have to be held liable before the two authorities for the same matter.

The Government of Armenia adopted a policy of supporting the business. This means that any regularization should at least aim to minimize: i) any possible impediments to the business and ii) reduce existing bureaucracy and paperwork in the way businesses enter the market.

A new administrative authority runs, per se, into conflict with the Government’s commitment to a supportive policy. Besides, problems of a legal aspect, particularly in the area of administrative lawfulness, emerge as follows:

- Article 9 of the Republic of Armenia Law on Administration Fundamentals and Administrative Procedure says that administrative authorities shall not have the right to demand from persons to taking action which these persons have already taken in the framework of other action or which are included or can be included with their content in the same framework. So, what we have now is a picture that when granting preliminary consent to qualifying
holding, the Central Bank draws up its conclusion right off concerning the possible adverse impact of the transaction in terms of restriction of free economic competition but then it additionally requires that the bank in question declare or report on concentration as the same case which the Commission reviews.

- Article 63 of the Republic of Armenia Law on Administration Fundamentals and Administrative Procedure establishes the principle of addressee trust in an administrative act, suggesting the addressee’s right to trust in the existence of that administrative act when what was received based upon that act has been used or owned, and when the return of what was received based upon that act will do harm to the addressee. Therefore, the person having been granted a preliminary consent of the Central Bank will not be found in a situation where that consent will not have been sufficient for him to obtain qualifying holding, and

- Article 24 of the Republic of Armenia Law on Legal Acts provides that where two legally binding normative documents run into conflict with each other, public authorities and local governments shall in their relationships with legal persons and individuals apply the normative document or part thereof which is preferable to the legal person or individual in question. This is another supporting argument that the Armenian financial laws provide for more favorable conditions for businesses, financial companies in particular.