**SUBMISSION 2**

# Issues in Competition in Retail Banking

## Comments on switching costs, exit fees and mergers in banking

Submission to the House of Representatives Standing Committee on Economics: *Inquiry into Competition in the Banking and Non-Banking Sectors*

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**Note**: This is a second and distinct submission to the Inquiry from the Submission dated 23rd June 2008 on 'AussieMac' (co-authored with Christopher Joye).

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## About

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## About the Author

**Joshua Gans** is an economics professor at Melbourne Business School in Australia. His research focuses on microeconomics, competition policy and innovation. He is the author of several textbooks and policy books, as well as numerous articles in economics journals. Gans received a Bachelor of Economics (Honours) and the University Medal from the University of Queensland before going to Stanford University to study for his Ph.D. in Economics. He graduated from Stanford in 1995 and moved to Melbourne Business School in 1996 as an Associate Professor and became a full Professor in 2000. In 2007, Gans received the inaugural young economist award from the Economic Society of Australia. This is an award given every two years to the best economist working in Australia, who is aged under 40.

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## Introduction

This is a short submission designed to highlight some key issues in competition in retail banking that, in my opinion, warrant new or on-going policy action. It is not designed to be a comprehensive treatment but a pointer to some key issues.

This submission emphasises (i) the constraint on competition arising from bank account switching costs; (ii) the potential constraint on competition from exit fees associated with mortgages; and (iii) a remark about on argument often proposed for banking mergers that I do not believe has sufficient foundation.

## Switching Costs

Competition rests on two factors. The first is that consumers have a variety of suppliers from whom to choose from. The second is that they face as few constraints as possible in freely making switches between suppliers. Without this second element, competitive pressure on alternative suppliers is relaxed and there is a loss in economic efficiency.

In retail banking, consumers face switching costs. To see this, consider what a consumer would have to do to switch to another bank if they were dissatisfied with their current one; say, because they have just increased interest rates or imposed a fee. These days many consumers have set up direct debits to get paid and pay regular billers (e.g., for phones, utilities, etc). If a consumer were to change banks these would all have to be set-up again with new numbers, new forms and new permissions. This is a cost of time.

And this is just for bank savings account. Things are even more difficult if consumers have credit card debt or a home mortgage (some issues of which I will discuss in the next section). To switch they would have to apply for a loan with another bank. If they have entry fees, these will have to be paid. And in some States, consumers will be lumped with stamp duties and other taxation charges.

In each case, to consider switching, the returns to doing so would have to exceed these switching costs. In our banking sector it is a rare instance where those returns are high enough. The offerings of different banks are not currently distinct enough. Moreover, any bank considering trying to compete for more business would have to make their products that much more attractive. Thus, for banks wanting to compete the cost of attracting market share is too high. Add to that possibility that a consumer switching will likely know they will then be beholden to their new bank and want to be assured there and the real costs are that much greater. It is a self-enforcing equilibrium of weak competition.[2]

There are actions that the Federal government can take to enable consumer choice to be exercised and to promote competition. This has already been recognised in other areas. In telecommunications, the government required mobile phone companies to make investments that would allow consumers to take their telephone numbers with them should they choose to switch providers. It is not even required that consumers tell their current provider that they are leaving. This removes a key switching cost and has strengthened competition in that sector.

It is possible to give competition in banking the same boost. The idea would be to transfer the ownership of bank account numbers and loan balances from banks to customers. What this would require would be a

[2] Joshua S. Gans and Stephen P. King, “Regulating Endogenous Customer Switching Costs,” *Contributions to Theoretical Economics*, Vol.1, Issue.1, 2001, Article 1.

common standard on bank account numbers (which we have in order to enable transfers between accounts of different financial institutions) and then an appropriate means of redirection when ownership changes.[3]

In Box 1, I respond to objections that were raised when I first floated this idea in January, 2008.[4] As is argued there, none of these objections are serious ones.

**Box 1: Potential Objections**

1. *"It isn't technically possible":* this is unlikely to be true. Phone companies said the same about number portability and there were all manner of difficulties that needed to be overcome there and that happened. We already have interconnected bank transfers which rely on your BSB and account numbers. The BSB operates like a 'call prefix' and like the case with phones could be part of the account number a customer can own. What is more, as bank transfers are 'low bandwidth' and 'non-continuous,' so the porting issues that faced phone companies are simply not there.
2. *"The market is competitive anyway":* The argument here is that with many banks and providers this is not needed. But if the market is competitive, this will not hurt. A risk-adjusted approach would ask us to ensure the fundamentals support competition even if there are other mechanisms that will assist.
3. *"There are prudential issues":* this is a standard bank objection to regulation just as utilities react against regulation because it will reduce investment returns and discourage innovation. When you hear 'prudential' issues, it means that "this will reduce profitability." Of course, that is part of the point. No one wants to see banks go under, but if it is allowing consumers the right to use competitive forces that will cause bankruptcy then there are bigger problems with the banking sector to contend with than retail customer mobility. It would also indicate that retail customers are cross-subsidising, other more risky parts of bank operations. That neither seems fair nor efficient.
4. *"There will be privacy concerns":* That said, there are privacy concerns now. Owning a bank number will not change that but it will allow you to choose banks more easily based on their security record.

**The returns to this move are potentially large. The customer bases of banks and other financial institutions will no longer be secure from competition. It is a power that the government needs to give Australian consumers if it is serious about making our retail banking sector more competitive.**

## Exit Fees

On constraint on consumer switching is the existence of exit fees. These are built into some mortgage contracts and so, any consumer wishing to change provider, would face these fees. The policy issue is: *should we eliminate exit fees?*

This issue is a complex one but one that I examined closely (motivated by concerns in telecommunications).[5] One reason for its complexity is that there are also entry fees associated with obtaining a loan. So even a consumer who faced no exit fees might face costs of switching imposed by alternative providers. In addition, lenders may argue that the costs imposed on them when a consumer exits are real and they should be permitted to cover those costs. However, as I discuss here, it is how they recover those costs that is the critical issue.

My research examined an environment where exit costs were real and were incurred by suppliers but that the market was otherwise competitive. In this situation, when attracting consumers initially, competition leads to an outcome whereby ... To see this, consider what happens when a consumer has chosen a bank and faces an exit fee. The other bank might bid for their business but if banks are equally efficient, no switching occurs because the incumbent bank can always 'out-bid' their rival just to save on the real costs associated with exit.

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[3] This idea has a history dating back to 2001. See Joshua S. Gans, Stephen P. King and Graeme Woodbridge, "Numbers to the People: Regulation, Ownership and Local Number Portability," *Information Economics and Policy*, Vol.13, No.2, June 2001, pp.167-180.

[4] Joshua Gans, "Switching banks a trying effort," *Herald Sun*, 10th January 2008.

[5] Joshua S. Gans, "Network Competition and Consumer Churn," *Information Economics and Policy*, 12, 2000, pp.97-109.

That said, the consumer does, however, face interest rates and other conditions that reflect any exit fees that might exist at the time. Thus, consumers will face higher on-going prices and fees when there are exit fees in their contract.

But what happens when they first apply for a loan and banks compete for their business? Those consumers know that they will have exit fees but what is relevant is the sum of establishment and exit fees. As banks know that ultimately consumers will not switch, consumers are offered a sum of such fees that reflect only the costs of establishing a loan and even these are discounted to take into account the ability of banks to recover those costs through higher on-going fees and interest rate charges.[6]

This suggests, that so long as consumers are fully rational, exit fees per se do not matter. Moreover, regulating them will only mean higher establishment fees and no net benefit to consumers in terms of on-going fees that offset this. Moreover, if consumers are not fully rational and say, overweight the present compared to the future, then they will be more willing to sign contracts with exit fees but competition will mean they have lower establishment fees as a result. However, the analysis of this becomes more complex.

Exit fees represent a switching costs but the evaluation of their efficacy and impact on competition is complex. To be sure, it is the real costs associated with gaining and losing a customer (that actual costs) that are the constraint. Those costs can be recovered using establishment fees, exit fees and on-going fees. There is an argument then that on-going fees are more natural and less likely to be confounded by issues associated with consumer rationality in choosing loan options. In my opinion, the regulation of exit fees requires a careful analysis of both competition and its interaction with consumer behaviour.[7] However, just because it is not complex does not mean that the investigation of this policy option is not worthwhile.

One final remark to be made here is that financial institutions might argue that the fees that exist are there to pay for the costs of verifying borrower riskiness. To be sure, there are real costs here when a consumer takes out a loan. But the question is whether those costs have to be incurred again when the consumer switches lenders. One option to minimise these costs would be for the government to setting up independent verification processes to allow the transfer of credit worthiness information between providers. Such issues represent opportunities for fruitful government intervention rather than blanket costs on that intervention.

## Mergers and scale

There has been renewed discussion about the 4-pillars policy that prevents mergers between the four largest banks in Australia. One argument is that competition issues can be addressed by the Australian Competition and Consumer Commission or the Australian Competition Tribunal. While true, it needs to be recognised that our *Trade Practices Act* is imperfect; for instance, it is unclear how to deal with multiple merger proposals (that is, the 4 into 2 scenario). Consequently, removing this policy is something that should only be done with care.

That said, one argument put forward for bank mergers is that, without mergers, they cannot achieve sufficient scale domestically in order to become internationally competitive. This argument, however, does not stack up against economic theory or evidence.

[6] My research shows that if for some other reason, consumers might switch, then exit costs will come into play to some degree.

[7] Joshua S. Gans, "Protecting Consumers by Protecting Competition: Does Behavioural Economics Support this Contention?," *Competition and Consumer Law Journal*, 13 (1), 2006, pp.40-50.

From a theoretical perspective, scale can be achieved by growth. A bank that grows domestically by out competing its rivals will develop the means to grow internationally. In addition, why should domestic scale be a pre-requisite for international competitiveness. Developing international operations will generate that scale too.

On the evidence side, it is not at all clear that scale has prevented the international competitiveness of Australian financial institutions. Macquarie Bank has led the charge but our other banks are hardly minnows on the world stage.[8] But similarly, in the US, while crimped by restricted state-based laws preventing large domestic banks, US banks achieved scale through international operations.

Consequently, **I urge the Committee to look very closely at both theory and evidence before revisiting the 4-pillars policy**.

[8] On his blog, Harry Clarke cites Fortune data that all of our four major banks are in the Top 500 companies in the world by revenue and Top 60 amongst banks. (see http://kalimna.blogspot.com/2008/06/four-pillars-policy.html)