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Pressing the switches

INCREASING COMPETITION IN RETAIL BANKING

*Most commentary on the UK's Independent Commission on Banking (ICB), which published its final conclusions in September 2011, has focused on the need to maintain financial stability and protect the taxpayer. Less attention has been paid to the ICB's ideas for increasing retail competition, where some old ideas have been given new polish. The Commission's final report suggests that it has moved on from a high profile divestment remedy to the fundamental causes of concern, where the argument has further to run.**

UK banking has certainly not lacked investigation over the past decade, with government and competition authorities in an almost permanent state of inquiry. Current accounts, business accounts; credit cards, store cards; savings, insurance products – all have been subject to special inquiries, many before the financial crisis. This attention has been driven by persistent concerns that prices do not necessarily follow costs, that customers do not always get the best offers – in short, that competition is not working as well as it could to deliver consumer welfare.

The financial crisis, of course, not only revealed the weakness of macro-prudential regulation, and provoked heated dispute about the relationship between investment and retail banks, but strengthened competition concerns. It led to the disappearance of a number of smaller banks, and the share of the top four in the personal current account market increased from 64% in 2008 to 77% in 2010. The shotgun wedding of Lloyds TSB and HBOS, rushed through by the Government without a competition inquiry, created further unease. Even when the EC forced disposals by both of the big government-supported banks (Lloyds and the Royal Bank of Scotland) for state-aid reasons, some still remained concerned about the dearth of smaller "challenger banks".

The ICB, set up with the primary purpose of designing a robust financial stability regime for institutions deemed too big to fail, was also required to look afresh at the day-to-day issues of competition. And in Professor John Vickers, the highly experienced professional economist who had served time at both the Bank of England and the Office of Fair Trading, it had the ideal chairman to chew both ends of the stick. Nevertheless, a full review of competition issues was a big ask for a body that was under pressure to come up with rapid answers to the stability questions, and had only limited resources. So its analysis builds heavily on previous work.

WHERE DO WE BEGIN?

Implicit in the ICB's final report and conclusions are three broad presumptions:

- "challenger banks" are good and big banks are bad;
- big banks will tend to price unfairly in one way or another; and
- concentration is a problem in itself.

Perhaps inevitably, therefore, in its interim report (published April 2011) the ICB had already reached the tentative conclusion that challengers needed support and that Lloyds Bank should be required to divest even more than the European Commission had required.

However, trying to recreate the pattern of the pre-crisis world was not an adequate way to address the issues of competition in retail banking. The spate of inquiries pre-crisis was clear evidence that slightly lower concentration ratios, or the existence of a few smaller banks, would not address concerns. Rather than simply seeking to turn the clock back by tinkering with structures, the ICB needed to dig deeper. And its final report shows that the Commission came some way to recognising this need.

Pressing the switches

The pre-crisis inquiries focused a good deal on two types of non-structural "remedies". One involved the use of various types of price cap for banking products – a direct intervention that recognised the "information asymmetries" in these markets, where customers find it hard to judge what they are paying for. However, such interventions are inevitably clumsy, easily outdated or worked around, and therefore regulators are rightly wary of them. So the preferred type of intervention laid weight on "transparency". Tell customers more, went the thinking, and you will empower them to increase competitive pressure. So product leaflets got longer, and font sizes got smaller, but it has to be said that customers did not seem to get much wiser.

Moreover, recent work in behavioural economics, and particularly studies into health and gambling markets, has produced powerful evidence on the limitations of using transparency to empower consumers. In many markets, giving customers more information changes their behaviour much less than you might suppose. At the very least, such strategies need to be targeted on increasing customer understanding, not just customer information. And that is harder both to achieve and to measure.

The key feature of many markets where regulators struggle with these issues is what is known as "switching costs". Where information is complex and burdensome to customers, they are reluctant to switch providers. On the face of it, this is a greater concern with current accounts than other products, such as utilities, as switching rates are usually found to be much lower. The ICB produced some figures showing that 5% of customers switched current account in the last 12 months compared with 16% for electricity. Banks tend to price aggressively to win customers, and the cost of attracting these new ones is borne by existing "sticky" customers. Almost every inquiry into retail banking has struggled with this issue.

It is also clear that the issue will arise whether five or fifty banks are competing for customers: it stems from the way competition works in these markets. At the levels of concentration we have seen in UK retail banking, both before and after the crisis, small movements in market shares will make very little difference to the problem.

THINKING AGAIN

There is evidence in the ICB's final report that its thinking has moved on. It contains much more emphasis on the need to ease customer switching and find new ways to make transparency a more effective tool for increasing customer understanding.

The ICB has not been able to pull itself away entirely from divestment remedies. But it has recognised that it does not mean Lloyds needs to sell more branches. Instead, the ICB wants to see its EC-driven divestment better funded, which is sensible, and for the resulting entity to have a market share of at least 6% in personal current accounts, rather than 4.6% as required by the EC. This second stipulation is more questionable. As an aspiration, it may mean the resulting entity is only 1.4% larger – but the logic behind it is a little fragile. And it is to be hoped that the Government does not create unnecessary damage in an attempt to force the issue

The ICB argues that "challenger banks" with market shares of between 5% and 12% have tended to grow faster than banks with smaller shares, and so 6% must be better than 4.6%. However, in truth there have been very few banks with market shares in the ICB's 5% to 12% range. Moreover, the bank that gained the most market share in a single year started at only 4%. Based on this evidence, it is far from clear that trying to force market share up a mere 1.4% would make any difference, either to the divestment's own growth prospects or – more importantly – to the competitive nature of the retail banking market.

ON THE BUTTON

Of more interest are the ICB's recommendations on switching. These include the idea of a new current account redirection service, which would reduce the time taken to switch and transfer the risks of switching (notably lost credits and debits) from customers to banks. This goes further than the Office of Fair Trading (OFT) recommended in its recent inquiry of personal current accounts.

Even if these changes trigger only modest increases in switching, they could have a powerful effect on retail banking competition – and far more impact on the growth prospects of "challenger banks" than trying to pre-determine market shares. Much depends on the detail; but this is the right way forward.

The ICB has emphasised the need for improved transparency to complement schemes to ease switching. Customers won't change bank, even if it is easier, unless they can see a reason for doing so. The ICB has left most of the detailed implementation of this aspect to the new Financial Conduct Authority, which takes over responsibility for ensuring that financial institutions "treat customers fairly" from the Financial Services Authority. This will be one of its most important first tasks. Recent attempts to improve transparency, such as those put in place by the OFT, focus on providing more information. The challenge will be to move on from information overload to improve customer understanding, which will require good research and a depth of knowledge of behavioural economics. But it is definitely a step in the right direction.

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