BANKING COMPETITION IN EUROPE: ANTITRUST AUTHORITIES AT WORK IN THE WAKE OF THE FINANCIAL CRISIS

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Abstract

In the financial intermediation industry, competition issues interact with those concerned with stability, as the current crisis unfortunately reminded us. This paper discusses and summarizes recent inquiries into retail banking undertaken by the European Commission and various National Competition Authorities, commenting on the methodologies and perspectives that these institutions have used to analyze competition in a sector which was for a long time considered "special". While the identified competitive problems and solutions closely match those highlighted by academic research, too little attention still appears to be given to risk considerations which would allow competition authorities to counter the likely forthcoming attacks which will again be aimed at isolating the financial industry from appropriate competitive checks.

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1 Introduction

Many people are asking themselves what will happen to competition policy in the face of the worst global financial and economic downturn since the Great Depression.[1] It is well-known that competition policy has often been sacrificed in the past during major emergencies, like crises and wars, for the sake of ‘other national priorities’.

In regular industries, competition policy had reached such high academic and social status before the crisis, debate on innovation notwithstanding, that we believe the effects of the crisis on antitrust enforcement will be contained.[2] Different is the case of the financial intermediation industry, one of the most heavily regulated sectors in the economy because of the important public goods it provides, its particular exposure to moral hazard problems, liquidity crises generated by loss of confidence and runs, and the risk of systemic crises through contagion. The current crisis dramatically testifies once again that the financial sector is not an industry like the others and that competition is again at risk of being subordinated to stability considerations.[3]

This paper reviews recent inquiries into retail banking markets carried out by several national and supranational competition authorities, trying to understand the degree to which their approaches to the financial intermediation industry have taken the important and special features of this industry into account and have been adapted accordingly.

Competition policy in the financial industry. As already mentioned, the financial industry is more prone to moral hazard problems than other industries. Extreme forms of moral hazard, from "tunnelling" part of investor money into private harbours by insiders to straight financial fraud, are particularly acute because of the extreme liquidity of the exchanged good - money - which keeps the direct costs of the "taking the money and run" strategy very low (if we consider other traded goods such as labour or physical capital, running becomes a rather more complicated endeavour). Milder forms of moral hazard, like "risk shifting", are also particularly acute in the financial industry as they are directly related to two of their more common features, namely limited liability and debt contracts. Moral hazard, if not contained by appropriate monitoring, tends to worsen the risk of loss of confidence on the side of investors and the consequent runs on financial institutions, thus also increasing the probability of systemic crises and the costly disruption of overall economic activity they bring along.

For these reasons, competition and price levels have often been seen as a secondary concern relative to that of monitoring moral hazard and preserving financial stability. Moreover, excessive risk taking has typically been seen as a negative side product of excessive competition between financial institutions, so much so that limiting competition (through entry regulation, and sometimes price regulation) had been one of the main tools by which financial supervisors tried to prevent banking crises in the past. The "charter (or franchise) value" theory of banking regulation suggested that too much competition would excessively reduce the future value of banking activity as it would consequently induce banks to take excessive risk.[4]

This long-standing paradigm was challenged in the decade before the current crisis. A number of studies have suggested that the detrimental relationship between competition and bank risk taking need not be robust.[5] In particular, a higher degree of competition may induce banks to become more

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[1] See e.g. the speeches held at the GCR symposium "Antitrust in Economic Crisis: a Global Perspective" held in October 2008, available at http://www.globalcompetitionpolicy.org/?id=55&action=903 and at the OECD roundtable on "Competition and Financial Markets", held in February 2009.

[2] See Fingleton, J. (2009) *Competition policy in trouble times*. Speech given at the annual Charles River Associate Conference 2008, Office of Fair Trading, for a more pessimistic view, envisaging a crucial role for competition authorities in counteracting attempts - with the excuse of the crisis - to obtain unwarranted protection from competition, subsidies or clearing from anticompetitive mergers that would likely delay, rather than speed up, the economic recovery.

[3] See Carletti, E., (2009), “Competition and financial markets.” *Background paper for the OECD roundtable*, Paris.

[4] See e.g. Keeley, M. (1990). “Deposit insurance, risk, and market power in banking”, *American Economic Review* (80), 1183–1200, and Da Rin, M., Hellmann, T., (2002), “Banks as catalysts for industrialization”, *Journal of Financial Intermediation 11, 366–397.*

[5] See, for example, the review in Carletti, E. (2008), “Competition and Regulation in Banking,” in “Handbook in Financial Intermediation,” Elsevier, North Holland, in A. Thakor and A. Boot (eds.), pages 440–482.

prudent once particular aspects of bank-firm relationships (e.g., entrepreneurs' effort) as well as the important functions and characteristics (e.g., monitoring) of banks are taken into account.[6] In this new framework, the relationship between competition and regulation also needs to be reconsidered. For example, higher capital requirements may lead to more entry and tougher competition with the consequence of improving monitoring incentives for higher-quality banks and worsening them for lower-quality banks.[7] Turning to the empirical evidence, several authors have found that virtuous behaviour by financial institutions tends to be observed more often in less-heavily regulated and more competitive financial markets.[8] Of course, the question of whether competition and good behaviour are jointly caused by other common factors, e.g. institutional quality[9], remains open to debate. In addition, empirical research has highlighted large costs for the economy from excessively restrictive regulation of the banking sector. For example, Beck et al. (2006), Demirguc-Kunt et al. (2004), and, particularly, Guiso et al. (2007)[10] suggest that excessively stringent bank regulation may have dramatic effects on nations' economic growth through its negative effect on competition and the allocation of financial resources.

Recent theoretical work also suggests that poor competitive conditions in the financial market tend to have a direct negative impact on competitive conditions in downstream industries by restricting firm entry,[11] fostering cartelization and hindering innovation.[12] Empirical studies of the relationship between financial and real sector market structure seem to confirm that a concentrated credit market tends to generate higher concentration in downstream industries[13]. Moreover, the recent intense consolidation phase experienced by the banking industry has strongly increased concentration in many countries around the world. Given that banks' profitability has also been growing faster than in most other sectors of the world economy,[14] and given the national character of most of the mergers and acquisitions taking place, it is hard not to envisage an increase in banks' market power generated by the consolidation wave.[15] However, some authors suggest that, although in the short term, consolidation generates adverse price changes, efficiency gains will dominate in the long run over the market power effect of mergers, leading to more favourable prices for consumers.[16]

The shift in the academic perspective in favour of bank competition and more friendly financial market regulation has accompanied a parallel shift in the way competition policy is organized and implemented. In many countries competition policy was not fully applied or not applied at all until

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[6]See Caminal, R. and Matutes, C. (2002), "Market power and banking failures," *International Journal of Industrial Organization*, vol. 20, 1341–1361, and Boyd, J. and De Nicolò, G. (2005), "The Theory of Bank Risk Taking and Competition Revisited," *The Journal of Finance*, vol. 60, 1329–1343.

[7]See Boot, A.W. and Marinc, M. (2007), "Competition and Entry in Banking: Implications for Capital Regulation," *SSRN eLibrary*.

[8] See Claessens, S. and Laeven, L. (2004), "What Drives Bank Competition? Some International Evidence," Journal of Money, Credit and Banking, vol. 36, 563–83.

[9] Moreover, Berger, A., Klapper, L. and Turk-Ariss, R. (2009), "Bank Competition and Financial Stability," *Journal of Financial Services Research*, vol. 35, no. 2, 99–118, found evidence that banks with a higher degree of market power have less overall risk exposure and a higher loan portfolio risk.

[10]See Beck, T., Demirguc-Kunt, A. and Levine, R. (2006), "Bank supervision and corruption in lending," *Journal of Monetary Economics*, vol. 53, 2131–2163, and Demirguc-Kunt, A., Laeven, L. and Levine, R. (2004), "Regulations, Market Structure, Institutions, and the Cost of Financial Intermediation," *Journal of Money, Credit and Banking*, vol. 36, 593–622, and particularly Guiso, L., Sapienza, P. and Zingales, L. (2007), "The Cost of Banking Regulation," Economics Working Papers 43, European University Institute.

[11]See Da Rin and Hellmann (2002) as note above 4, and Cestone, G. and White, L. (2003), "Anticompetitive Financial Contracting: The Design of Financial Claims," *The Journal of Finance*, vol. 58, 2109–2142.

[12] See Bhattacharya, S. and Chiesa, G. (1995), "Proprietary Information, Financial Intermediation, and Research Incentives," *Journal of Financial Intermediation*, vol. 4, 328–357, and Spagnolo, G. (2004), "Debt as a (Credible) Collusive Device, or: "Everybody Happy but the Consumer"," Mimeo, University of Tor Vergata.

[13] See Cetorelli, N. and Strahan, P. (2006), "Finance as a Barrier to Entry: Bank Competition and Industry Structure in Local U.S. Markets," *The Journal of Finance*, vol. 61, 437–461, and Cetorelli, N. (2004), "Real Effects of Bank Competition," *Journal of Money, Credit and Banking*, vol. 36, 543–58.

[14]See Carletti, E., Hartmann, P. and Spagnolo, G. (2002), "Implications of the Bank Merger Wave for Competition and Stability," *Risk Measurement and Systemic Risk - Proceedings of the Third Joint Central Bank Research Conference (Board of Governors of Federal Reserve System, Bank* of Japan, European Central Bank).

[15]See Bikker, J. and Spierdijk, L. (2008), "How Banking Competition Changed over Time," Working Papers 04, Utrecht School of Economics.

[16]See Focarelli, D. and Panetta, F. (2003), "Are Mergers Beneficial to Consumers? Evidence from the Market for Bank Deposits," *American Economic Review*, vol. 93, 1152–1172.

recently in the banking sector. As documented by Carletti et al. (2008) and Carletti and Vives (2007),[17] most European countries have introduced or strengthened merger control between 1987 and 2004, but some countries retained certain measures for the banking sector until very recently. For example, competition policy in the banking sector in Italy was applied by the Bank of Italy in its role of banking supervisor rather than by the competition authority until December 2005. In the Netherlands, the Competition Act entered into force in 1998, but the banking sector was excluded from its application until 2000. Similarly, in Portugal, merger control was introduced in 1988 but the banking sector was excluded until 2003. Finally, only a decision by the Supreme Court in 2003, made during the appeal against the decision of the Commission Bancaire for the merger between Credit Agricole and Credit Lyonnais, made it clear that the banking sector was subject to merger control in France. Despite these exceptions, in general the design of competition policy as well as its implementation in the banking sector has been substantially strengthened at the national level over the last two decades.[18] These changes, besides causing important re-allocations of staff and resources, and the creation of protocols for the collaboration between financial regulators and competition authorities, led to the latter launching wide-ranging sector inquiries to try to understand the real competitive situation in this largely unknown and complex sector.

The crisis. These changes in policy and perspective faced a sudden halt with the advent of the current crisis. Some official reports have described the current crisis as a problem of excessive competition in banking.[19] The various rescue plans for the banking sectors were directly based on state aid, to the extent of forcing the European Commission to adopt, under EC Treaty state aid rules, a temporary framework providing Member States with additional possibilities to tackle the effects of the credit squeeze on the real economy.[20] Individual bailouts led to centrally-coordinated mergers among main players in the banking industry though these mergers were - or would have been - challenged by competition authorities under normal conditions.[21] This emergency phase is likely to go on for quite some time, but a more important concern is probably about the long-term effects of this change with respect to competition policy in the financial intermediation industry.

In light of the crisis and of the dominant concerns for financial stability, the present paper reviews several recent reports originating from competition authorities' sector inquiries, mainly focusing on the retail banking market. The aim is to understand the methodology and the perspectives that competition authorities have been using in analyzing competition in this novel and different sector. For the many reasons discussed above, the banking industry is somewhat special and needs particular care in the way in which competition is analyzed and implemented. Our aim is to describe and comment on the sector inquiries by competition authorities from an academic perspective, trying to understand whether their results are in line with academic research on bank competition. The recent OECD survey by Degryse and Ongena (2007) nicely summarizes what appears to be the main competitive concerns in the

17 See Carletti, E. (2008), "Competition and Regulation in Banking," in "Handbook in Financial Intermediation," Elsevier, North Holland, in A. Thakor and A. Boot (eds.), pages 440–482, and Carletti, E. and Vives, X. (2007), "Regulation and Competition Policy in the Banking Sector," WP Centre for Financial Studies.

18 Carletti, E. and Vives, X. (2007), as note above 17.

19 For example, the President's Working Group Financial Market (2008), "Policy Statement on Financial Market Developments," Tech. Rep available at http://www.iasplus.com/crunch/0803pwgpolicystatement.pdf, stresses that the new complex financial instruments, which triggered the crisis, are the results of competition and of the desire to maintain, under competitive markets, high returns.
De Larosière Group (2009), "High level group on financial supervision - De Larosière Group report," Tech. rep. available at http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf, addresses - this question emphasizing that exceptionally low interest rates, combined with fierce competition, pushed most market participants to search for higher returns, whether through an increase in leverage or investment in more risky financial products. However this report also stresses the importance to preserve competition throughout the EU internal market.

20 The Framework is part of the measures announced by the Commission in its 26th November European Economic Recovery Plan (see IP/08/1771) and was approved in record time following consultation with Member States.

21 Vickers (2008), "The Financial Crisis and Competition Policy: Some economics," Speech given at the Annual Charles River Associate conference 2008 available at http://www.oft.gov.uk/news/speeches/2009/0109 provides a nice discussion of why clearing the most likely anticompetitive merger between Lloyds TBO and HBSO was not a good way to maintain financial stability.

banking industry (switching costs, credit bureau, ATM cards) looking at the accumulated academic empirical work on bank competition.[22]

Going one step further, our interest is to understand whether competition authorities have been adapting their approaches to the peculiarities of the financial industry so as to counter the likely criticism that will come in the wake of the financial crisis. Furthermore, we suggest potential improvements that could help better understand the competitive situation in the financial industry. It is encouraging to notice that, although the sector inquiries could be improved methodologically in one way or another, they tend to agree with the academic literature on what seem to be the main current competition concerns in the retail banking sector (i.e., switching costs). Somewhat less close to academic research appears instead the way in which issues related to risk are often (not) taken into account in these reports.

The structure of the paper is as follows. In the next section, the European sector inquiry is presented. Due to the large coverage of topics, the focus will mainly be on issues that might have a direct effect on customers. In Section 3 the inquiries undertaken by the Italian, Irish, British and Nordic Competition Authorities are presented. For each of these inquiries, there will be a paragraph summarizing the main results as well as the actions that authorities have identified in order to increase competition among banks. We report our comments on the methodological issues and on the approaches used at the end of each paragraph. In section 4, we briefly discuss the implications resulting from increased enforcement of competition rules during the economic crisis. The conclusions are contained in the final section.

2 The European Sector Inquiry

The final report on the sector inquiry of the European banking system, conducted by the European Commission (EC) in 2005, was published in January 2007. It examines two main areas within the retail banking sector: payment cards and current accounts and related services. Its findings mainly build upon the conclusions of its earlier Interim Report I - Payment Card (12 April 2006) - and Interim Report II - Current Accounts and Related Services (17 July 2006).[23]

The retail banking sector, which provides services not only to consumers but also to small business, represents the most important sub-sector of banking activity in Western Europe, accounting for more than 50% of total banking activity measured by the gross income indicator. In 2004, it generated a gross income of between 250-275 Euro billion, equivalent to around 2% of EU GDP.

The collected information covers the period 2002-2004 and has been gathered through a market survey of 250 banks (out of 8000). In addition, the Commission has examined the roles of several actors, also gathering information from bank associations, banking regulators, national central banks, credit registers, and national competition authorities (NCAs). The Commission has also taken the views of consumers and small business' into account through surveys of the relevant national associations.

The inquiry has found evidence of convergence of bank prices and policies within Member States as well as sustained high profitability. Though high profitability could be the result of various factors, such as business cycle, favourable macro-financial conditions, risk or increased efficiency, the EC has identified a number of factors which might possibly suggest lack of competition. In the following section, we will illustrate the report's findings on current accounts, and then we will turn to payment cards. In both cases, the focus will be mainly on issues that have a direct impact on customers.

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[22] See Degryse, H. and Ongena, S. (2007), "Competition and Regulation in Retail Banking: Background Paper," *Background Paper: Competition and Regulation in Retail Banking, OECD Competition Committee Roundtable*, vol. 69, 15–58.

[23] See European Commission (2007), "Report on the retail banking sector inquiry," Tech. Rep available at http://ec.europa.eu/comm/competition/sectors/financial_services/inquiries/retail.html

2.1 Current Account and Related Services in Europe

In the current account segment, the main competition issues identified by the Commission can be grouped into concerns related to the supply and demand side. Competition concerns on the supply side relate to access to credit registers and other banking infrastructure, to certain a type of cooperation among banks and to pricing and selling policies whereas concerns on the demand side mainly relate to switching costs.

Supply Side Concerns The first concern is related to *credit registers*, which are registers collecting financial information on individuals. The members of the registers are able to access the data stored, reducing asymmetric information onto debtors.[24] In this regard, three sets of barriers all with a potential impact on competition have been identified: *i)* unfair or discriminatory access conditions, *ii)* partial data sharing, and *iii)* regulatory barriers.

Concerning the first issue, specific requirements in order to gain access to the credit register might weaken competition. For example, in some countries, the reporting institution needs a physical presence in the country. Partial data sharing could occur if market coverage is low or in case of incomplete reporting. The report showed a striking divergence in the level of coverage of credit registers across the EU, with the majority of high coverage credit registers in the EU15.[25] Regulatory barriers could also impact on competition. For example, in Spain, the interpretation of existing laws, recently removed by the ECJ in the ASNFEX-Equifax case, has acted as a barrier for some credit data providers. In addition, credit information markets turned out to be fragmented along national lines, with just few credit bureaus that conduct cross-border reporting.[26]

The inquiry also pointed out the existence of *fragmented legal infrastructure*, with tax policies on company earnings, VAT treatment and capital gains varying between Member States. Clearly, these varying tax regimes influence the investment decisions of banks to enter new markets as well as the saving and borrowing decisions of retail banking customers.

The EC identified *the level of cooperation* among banks as another important factor affecting the level of profitability and competition in the retail market. The nature of retail banking activities creates scope for formal co-operation among market players. Though certain types of co-operation may be necessary (i.e., creating standard), others can also lead to collusion and/or to the exclusion of third parties. In particular, the report stressed cooperation between cooperative and saving banks, which traditionally have strong co-operative ties and cover a significant proportion of retail banking in Europe.[27]

Price setting is the last important issue. It is well known that firms try to attract new clients with aggressive price policies and then, when the customer is locked, charge higher prices. The inquiry reported that banks generally provide special offers (free banking costs, preferential interest rates, discount on other products, cash incentives) for new customers. Only in the Netherlands and Belgium, do the majority of surveyed banks not offer incentives to new customers. In particular, there is strong evidence of significant variation in prices within and across Member States, regardless of the

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24 The EC's report has identified three types of credit registers: private systems (Denmark, Estonia, Finland, Greece, Cyprus, Hungary, Ireland, Malta, Netherlands, Poland, Sweden, UK), public systems (Belgium and France), and dual systems (Austria, Czech Republic, Germany, Italy, Latvia, Lithuania, Portugal, Slovakia, Slovenia, Spain). Luxembourg has no credit registers at all. The vast majority of registers require reciprocity as well as data protection (national laws/European data protection directive).

25 Where the coverage of credit registers is low, larger banks are likely to have an advantage since their extensive client book will enable them to build more accurate risk models than small competitors. This advantage is even stronger where credit registers is only limited to negative data and full reporting is not a legal obligation. The larger banks, in fact, have no strong incentives to ensure full information disclosure, enabling rival banks to access their client information.

26 "..[]The lack of cross-border credit reporting may create problems for consumers who are mobile and seek to borrow in more than one Member State. Currently they are generally required to build up separate credit histories in order to obtain credit, whether in the form of a mortgage, personal loan or credit card. Moreover, consumers who move permanently to another Member State might have problems accessing credit and telecom services, because their credit report cannot be transferred to their new residence state.[]..European Commission (2007)"

27 Cooperative banks play an important role in France (the first 4 cooperative groups account for around 50% of the overall national retail sector), in the Netherlands (the first group accounts for 40% of the national retail market), in Finland (the first group accounts for 30% of the national retail market), in Italy (Banche Popolari and Credito Cooperativo account for 25% of the national retail market) and in Austria (the first 2 associations account for 20-25% of the national market). Saving banks play a major role in Germany and Spain, where they together account for roughly 30 to 50% of the different national retail activities. Saving banks are important in Luxembourg, Austria, France, and Italy.

parameters used: management fees; closing charges; excess borrowing fees; fees for ATM withdrawal; fees for credit transfers.[28] In spite of significant differences between Member States for some type of current account fee, convergence in pricing behaviour can be observed in several Member States.

Demand Side Concerns There are countries, such as the Netherlands, in which customers are highly satisfied with their relationship with banks (94%, as reported in KPMG (2004)'s inquiry)[29], and other countries in which only a smaller fraction of customers are satisfied with their banks (for example, in Italy only 56% of customers are satisfied).

Two important indicators of *customer mobility* were reported: longevity of current accounts and churn rate. Churn rate captures the share of customers who change providers in a given year, while longevity measures the average age of an existing banking relationship. To test the relationship between customer mobility and market performance a univariate correlation analysis has been implemented. At bank level, results showed a positive correlation between longevity and profitability, and a negative correlation between mobility and market concentration. A multivariate analysis, also controlling for country effects, confirmed that higher churning and lower longevity are related to lower profitability in retail banking, suggesting that banks face greater pressure on profits where customers are more mobile.

The sources of *switching costs* identified in the reports are: administrative burdens, information asymmetry and price transparency, closing charges, and bundling and tying. Concerning this latter issue, the report evidenced the common bank practice of tying and bundling products. In some cases, this practice may, of course, enable banks to offer a wider range of products. However, in others, product bundling, and in particular tying, may weaken banking competition. Moreover, the inquiry's data suggested that in almost all Member States where the largest bank ties its products, the majority of its competitors choose to follow.

Actions to increase competition The inquiry's main recommendations for the market for current account are related to:

- *Credit registers*: unfair access, partial data sharing, and regulatory barriers may be addressed through competition law or with full enforcement of data protection rules;
- *Cooperation among banks*: the effects on market competition has to be analysed on a case-by-case basis. Should it turn out that one or more of these cooperations raise antitrust issues, the Commission would take those cases up with a Community dimension.

2.2 The market for payment cards in Europe

The number of electronic payments (card payments, credit transfers and direct debits) has constantly increased, progressively replacing payments traditionally made with paper instruments (cheques) and cash. In 2004, cashless payment transactions in the EU amounted to 65.3 billion transactions. The total number of cheques declined from 8.9 billion in 2000 to 7.5 billion in 2004, whereas the total number of electronic payments increased from 37.9 billion in 2000 to 57.9 billion in 2004. The most common electronic instrument was the payment card, representing 41% of the total cashless transaction volume.
Disregarding many of the issues investigated by the Commission, we only focused on those issues that might have a direct impact on customers, i.e., cardholder and merchant fees.

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28 Account management fees vary a lot across countries and are particular high in Germany (40 euro) and Italy (90 euro), even if both in Italy and Germany there is a great variability. The weighted average for EU25 is 14 euro. Closing fees are particularly high in Italy (60 euro) and Luxembourg (100 euro). Excess borrowing fees are, on weighted average, around 10% of total current fee income but are higher in France, Spain, UK and Cyprus (almost 1/4). Fees for ATM withdrawals (based on a simulation of 100 euro ATM withdrawals) are, on weighted average, equal to 1.14 euro for EU25. In Italy it is 2 euro with a greater value of 5.50 euro. Fees for credit transfer (based on a simulation of 100 euro credit transfer, both "on us" and "off us") are equal to 1 and 2 euro respectively. The most costly country for "on us" credit transfer is Greece and France for "off us" credit transfer.

29 See KPMG (2004), "Banking Beyond Border: will European Customers Buy it?" Tech. rep. available at http://www.us.kpmg.com/microsite/FSLibraryDotCom/docs/209246%20FS%20Banking%20Beyond%20Borders%20survey%20v3.pdf.

Results Even in this segment of the retail banking industry, the substantial variation in merchant and cardholder fees across Member States suggests that markets still remain fragmented. Credit card issuing turned out to be very profitable. In most Member States the average profit ratios remained stable over the period 2002-2004.

There are four types of *cardholder fees*: the fee per card, the card issuance fee, the fee per transaction, and the account statement and billing information fee. Among these, the annual fee per card is the most widely used and the most important component of cardholder revenues in the EU-25. Correlation analysis has not shown evidence of a strong negative relationship between the level of the cardholder fee and the level of the interchange fee, challenging the hypothesis of the economic literature which states that an increase in interchange fee is fully offset by reductions in cardholder fees. Regarding the *merchant service charge* (MSC), which is the price that a retailer has to pay per transaction to the credit card acquirer, the most important concern is related to the fee paid by smaller merchants. In fact, by disaggregating the size of merchants, it turned out that smaller merchants are charged 70% more than larger merchants. The differentiation of prices according to size - not justifiable by transaction volumes - could indicate the exercise of market power.

The analysis also revealed `*blending*' as a frequent phenomenon across the EU-25. Blending refers to a situation where the same MSC rate is offered to merchants accepting cards issued in two or more different networks. From a competition perspective, the Commission considers that the clause prohibits the merchant to surcharge customers for the use of the card (or granting a discount to customers paying in cash) as a restriction of the merchant's freedom to pass on the transaction costs to cardholders.

Actions to increase competition The ban of surcharging may constitute a barrier to entry for alternative non-cash payments. *Allowing surcharge* would strengthen the incentive for consumers to use cheaper payment instruments.

2.3 Comments to the EC's sector inquiry

The report´s outstanding feature is its wide coverage, both in terms of geographical areas (EU15, EU25) and of investigated issues (deposits and loans, credit bureaus, payment cards). The methodologies are usually clearly stated, as well as data limitations and inference problems.

The report sheds an important light on the link between switching costs and ownership, emphasizing how the interaction of these two elements may represent a barrier to entry. Market practice, in fact, suggests that switching costs tend to limit prospects for market entry. For example, foreign banks seeking to establish large full service operations in another Member State typically do so through mergers and acquisitions, as greenfield entry is generally perceived even more risky when customer mobility makes it difficult to acquire scale in a viable time period. However, in markets where co-operative banks have a significant market position, this is the only viable way to enter. In fact, a common feature of co-operative banks is the 'one man one vote' principle, independent of the shares an individual member holds. A take-over of co-operative banks or banking groups by other banks is, therefore, excluded.

In this report, banks were also asked to indicate whether they offered preferential conditions to new clients. This exercise of splitting consumers in "new business" and "outstanding amounts" is valuable since it allows looking at banks' penetration strategies to later lock in exploitation. On the methodological perspective, the report also gives important insights into factors, such as demography variables, market growth and longevity, which are necessary to control when estimating churn indicators.

Notwithstanding these important insights, however, some remarks are necessary. These are almost all related to a traditional view of competition in the banking sector.

First of all, despite the effort to create a representative sample, larger banks seem over-represented. It is not clear whether considering local banks may affect the results. Making comparisons across European countries, in fact, may not give the same insight one can get by investigating how demand

and supply interact at regional level, where competition is probably at play and where it is easier to control other factors (for example, different taxation). In particular, the report completely avoids the problem of defining the size of the relevant market, and for all the Member States it is simply assumed to be equal to the national territory. However, for some countries, such as the UK, it may represent a reasonable assumption whereas for other countries, such as Italy, it may be wrong. As a consequence, the price comparisons stemming from such definitions could be incorrect.

The most important aspect was that the investigation relied on traditional indicators of competition and concentration. As Claessens and Laeven's (2004) analysis shows,[30] variables describing the banking system structure may not provide good summary statistics for a competitive bank environment. Conversely, these authors found that more concentrated banking systems face a greater degree of competition. For example, in Belgium, it is possible to observe a high level of concentration and low level of profitability, whereas in other countries the reverse is true. In this regard, nowadays, new and better measures have been developed. For example, Boone et al.'s (2007) indicator of competition[31], which measures the percentage fall in profitability caused by a percentage increase in costs, or total factor productivity, is considered a better cost-based measure.

Finally, it is worth highlighting the EC's view on the effects of risk when studying bank profitability: "Looking at profitability may yield important information for competition analysis. In fact, while the existence of significant rents may be the reward for taking risks and innovating, superior efficiency or better management, they could also be the result of having and exerting market power. High and persistent rents in relatively mature markets where some prices, such as interchange fees, are determined collectively may suggest the latter. These findings, together with other evidence obtained by this inquiry, may reveal whether a firm or a group of firms exercise market power to the detriment of consumers in a particular market". This paragraph nicely summarizes the marginal role of risk in this inquiry. Before this crisis, despite having been recognized as a possible determining factor in banking competition, risk had not been considered a prominent one by at least some competition authorities.

3 Competition in National Systems

The retail banking sector has recently attracted the attention not only of the European Commission but also of several National Competition Authorities (NCAs). Retail banking markets still remain inward-looking across all countries in Europe. A combination of high entry barriers, the existence of network effects, a lack of transparency and high switching costs for customers, led NCAs to the view that, despite their efforts in enforcing competition law, competition in national retail banking markets remains far from perfect.[32] In the following sections, we will present the reports undertaken by the Italian, Irish and Nordic Competition Authorities.

3.1 Competition in the banking sector in Italy

In 2006, the Italian Competition Authority began a sector inquiry aimed at determining the types and level of the prices charged to bank customers for current account and payment services.[33] The analysis was based on questionnaires administered to 72 banks operating in Italy, covering 68% of branches and distributed to all geographical areas. Each bank was asked for the types of current account offered (new and past offers), the economic conditions applied to these accounts, the existing ties linking to other services, and any constraints on closing. In particular, banks were also asked to indicate the 'most convenient' current account for each of the 10 hypothetical types of current account holder.[34] In

30 See above note 8.

31 See Boone, J., Ours, J.v. and Wiel, H.v.d. (2007), "How (Not) to Measure Competition," *Discussion Paper 32, Tilburg University, CentER for Economic Research.*

32 See ECA (2006), "Competition Issues in Retail Banking and Payment Systems Markets in the EU," Tech. rep.

33 Italian Competition Authority (2007), "Indagine Conoscitiva riguardante i prezzi alla clientela dei servizi bancari," Tech. rep. IC32 available at http://www.agcm.it

34 The profile are: *1.* Young first-job seeker with occasional employment, living with parents, needing a pre-paid payment card and carrying out online current-account transactions; *2.* Thirty-year-old with a regular job, single, no children, living in a rented apartment, needing

addition, this inquiry paid attention to the amount and the quality of the information supplied to the account holder.

3.1.1 Current Account and Related Services in Italy

The findings highlighted two types of current account offered: *flat* accounts with a fixed yearly charge as opposed to *transaction* accounts. The former are not all-inclusive package accounts but, in general, combine account-holding costs (bookkeeping costs, charge and account statement expenses), and in some cases direct debit as well, in the single annual charge. The account holders must therefore pay fees for many other transaction-related services. The inquiry particularly stressed the Italian banks' growing tendency to market this kind of account.

As to the cost of a current account, the inquiry estimates the weighted system average of 182 Euro per year. For only two profiles the cost turned out to be less than 100 Euro, for another two it was in between 100 and 150 Euro, and for the remaining six profiles it was above 200 Euro. The study also examined the cost dispersion by measuring the degree of variation for each profile. It turned out that consumers who *shop around*, that is, compare offers from different banks and select the most economical, can achieve sizeable savings on their accounts.

Finally, the inquiry compared the cost of a current account in Italy with those determined by other studies, finding that customers in Italy paid a higher price for a current account than in all the other countries considered.

In light of this, the Authority identified various obstacles to competition which may limit customer mobility and, therefore, lead consumers to sub-optimal choices. First and foremost, the inquiry highlighted the standard commercial practice among banks of providing separate information sheets for each service and referring to the cost items contained in a number of different sheets. Of course, this practice overloads consumers with data which may be of little help in selecting the most economical product. The second category of factors that may impede customer mobility are entry and exit fees, long and/or uncertain time for entry and exit, the cost of ties between banking and/or financial services, and the cost associated with the lack of transparency and the complexity of products. The inquiry, for example, showed the cost of closing a current account being as much as 150 Euro and that of transferring securities up to 80 Euro for each security code. However, it must be noted that after the Bersani Decree (Law 248/2006), some banks (but not all) eliminated the cost for closing services.

Apart from the aforementioned cost, the inquiry identified the length of time required to switch from one bank to another as another impeding factor to mobility as well as the ties between various banking and financial services. For example, the report indicated that 63.6% per cent of banks do not allow the switching customer to continue to use the bank's custody and administration service, 18% do not allow him to keep his mortgage loan, and 21% cut off personal loans.

Finally, the Authority highlighted the widespread practice of product tying, that is the practice of the sale of a product conditional upon the purchase of another. In this regard, 64% of the surveyed banks require customers to have a current account in order to buy or sell securities; 42% require it in order to grant a mortgage loan, and over 90% require it to issue a credit card.

ATM-POS and credit card, carrying out online transactions; *3.* Thirty-year-old with a regular payroll job, single, no children, living in a rented apartment, needing ATM-POS and credit card, carrying out online transactions, requiring overdraft facility and direct debit of utilities; *4.* Single-income employee family, no children, needing ATM-POS card, credit and mortgage loan; *5.* Two-income employee family with growing children, needing ATM-POS, credit card, credit, direct debits, mortgage loan and asset management; *6.* Single-income family, self-employed craftsman, with growing children, carrying out numerous transaction, needing credit and asset management; *7.* Single-income professional family with growing children, carrying out a large number of transactions and needing securities custody services; *8.* Pensioner, no dependents, few transactions; *9.* Pensioner family, no dependents, needing ATM-POS, direct debit of utilities and asset management; *10.* Pensioner family, no dependents, needing ATM-POS and credit card, direct debit of utilities, carrying out online current account transactions needing securities custody services.

Actions to increase competition The inquiry proposals can be grouped into actions aimed at:

- *enhancing transparency* through better modes of communication to the advantage of current account holders. For example, an indicator of the overall cost of an account, a single-item summary of all the possible costs of services, a guarantee of stable costs for account-keeping, an online search engine for comparing the cost of different current accounts;
- *improving customer mobility* through elements that facilitate the ability to switch banks. For example, in the case of the exercise of *ius variandi*, a statement of the overall impact of the terms altered; a procedure to keep the services connected to the current account while switching bank; a maximum time limit for an account switch; account portability.

3.1.2 Comments on the Italian Fact-Finding Investigation

The inquiry, very clear and well-written, represents a first serious attempt to analyze the market for current accounts in Italy.

The inquiry deserves great credit for differentiating the demand into ten profiles instead of considering products and customers as homogeneous. This kind of analysis represents an important, though indirect, way to account for differences in product quality and consumers' risk profiles. However, it might be the case that these ten profiles are not fully representative. For example, a family with two incomes and no children is not included in the profiles. In this regard, it could be helpful to look at population statistics.

The most striking result is the high variability in costs within each profile, that basically remained unexplained. On the contrary, it is very important to understand why the costs of current accounts are generally above the cost of the "optimal account" indicated by the banks. For example, it would be better to relate the cost variability to type of banks or macro-areas. As Guiso et al. (2007) show,[35] in fact, a peculiarity of the Italian banking system is the presence of different territorial dynamics. Moreover, in order to really understand if a bank really offers the best account, it is necessary to compare the most convenient account offered by each bank with the effective accounts offered to customers of the same bank.

Finally, some important questions still were left unanswered.

Are consumers really uninformed (or irrational), or can other factors explain their choices? As suggested by Cerasi (2007),[36] more attention has to be paid to branches. In fact, customers may be more willing to pay a higher price if the bank offers a greater network of branches, in the local market as well as at the national level. In this regard, it is important to underline that Italy is the only country in Europe where it is possible to observe a growing trend in the number of branches, despite the number of customers being rather stable.

Can supply side factors explain different costs of the most convenient accounts? The inquiry mainly focused on the demand side, somehow neglecting supply side factors. As Drummond et al. (2007) indicate,[37] Italian banks have high operating income but also high operating expenses. By simply looking at the prices charged on current accounts, it overlooks other important factors affecting banks' profitability with risk and costs coming first.

To conclude, despite its limitations, the Italian inquiry - by differentiating demand into ten consumer profiles - contains an important suggestion for an analysis of banking competition that accounts for different degrees of risk and product quality. Nonetheless, this inquiry also does not deal with risk-adjusted measures when assessing bank prices and profits.

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[35] See as note above 10.

[36] Cerasi, V. (2007), "Più Concorrenza nel Mercato dei Depositi Italiani: una Riflessione sull'Indagine Conoscitiva dell'Autorità Garante della Concorrenza e del Mercato," *Economia e Politica Industriale*, vol. 2, 169–179.

[37] Drummond, P., Maechler, A. and Marcelino, S. (2007), "Italy-Assessing Competition and Efficiency in the Banking System," *IMF Working Papers* 26, International Monetary Fund.

3.2 Competition in the banking sector in Ireland

The Irish Competition Authority launched its study of competition in (non-investment) banking in September 2002.[38] It presented the final report in year 2005. The final report focuses on three specific areas: personal current accounts (PCAs), lending to small business (SMEs) and the payment clearing system. During the course of its investigations, the Competition Authority examined over 100 boxes of bank documentation submitted under summons and conducted interviews with senior bank personnel. The Competition Authority found no grounds to initiate proceedings under section 4 or section 5 of the Competition Act. However, the Competition Authority makes 25 recommendations designed to promote more vigorous competition.

3.2.1 Current Accounts and Related Services

The personal current account market in Ireland is highly concentrated with two firms sharing well over 70% of the market. A number of barriers to switching current account provider were identified in the course of the study: the difficulty of the switching process, a lack of price transparency, the method of collecting stamp duties on plastic card, and the fear of losing credit histories. However, since the Competition Authority commenced its study, a number of changes in the Irish banking market have occurred which have the potential to increase competition in the PCA market.

In particular, the Irish Bankers Federation (IBF), launched a PCA Switching Code in January 2005 that facilitates personal customers to move their current account to another bank. Furthermore, the Minister of Finance endorsed the ending of the double-taxation of stamp duties on customers who switch bank. Stamp duty on plastic cards inhibited switching since consumers who switched bank accounts with services such as ATM or Laser cards effectively paid stamp duty twice.

Another impediment identified by the Competition Authority is anti-money laundering requirements which confer an advantage onto banks with extensive branch networks, who find it easier to compete for customers than banks with smaller networks or no network at all. A peculiar feature of Ireland is that it is the only country, other than Kenya, that attempts to regulate the price of banking services. Bank charges are regulated both in terms of notifying customers and the level of charge allowed, but it does not cover interest margins. Finally, price transparency appeared to be a crucial factor as information provided to customers is inadequate and complex in presentation.

Action to increase competition The Competition Authority's recommendations relate to:

- *increasing the ease and speed of the switching process* through standard procedures for accepting and transferring personal identity information;
- *improving pricing information* by providing, for example, customers with personal current account interest rate information;
- ensuring consumers their *credit histories*. The fear of losing a credit history, and the consequent difficulty of demonstrating creditworthiness, constitutes a barrier to switching. In addition to facilitating consumers' switching, the provision of credit history will facilitate market entry, since new entrants face reduced risks and costs.

Finally, even if it considers price regulation a poor means of promoting competition, the Authority recommends delaying its removal until there is more of a competitive landscape in Irish banking.

[38] Irish Competition Authorithy (2005), "Competition in the (non-investment) banking sector in Ireland," Tech. rep. available at http://www.tca.ie/EN/Promoting-Competition/Market-Studies/Banking.aspx

3.2.2 Loans to small business

The Competition Authority has focused on working capital loans because they are particularly suited to small business and are not readily suitable for other forms of lending, such as term loans. Business current accounts, such as personal current accounts, are characterized by rigidities which make it difficult for customers to switch their account provider. However, it is even more difficult for small business to move their current account from one bank to another than it is for personal customers. This is due to the volume of transactions and the use of a current account to the monitoring of on-going credit state of business.

Actions to increase competition The Competition Authority recommends:

- *an easier process* to move loans and current accounts to a different bank thanks to a business switching code as well as free account histories;
- *an easier transfer of the security* provided against the loan. For example, to rely on a standard form of mortgage documents;
- ensuring small business receive *free account history* at least once a year;
- ensuring small business receive *accurate information* on alternative products.

3.2.3 Payment clearing system

The structure of the payment clearing system has inhibited new bank-offering services in Ireland. Clearing company governance structures and application procedures might have discouraged new banks from joining the clearing system. In addition, Ireland's continued high reliance on paper transactions, such as cheques, implies high investment in expensive paper sorting technology that raise costs and reduce the competitiveness of new entrants.

While Automated Clearing Houses (ACH) operate in numerous EU member states, in Ireland payment schemes are operated on a bilateral basis. This implies that each participating institution has to agree terms with every other participating institution. The Central Bank and Financial Services Authority of Ireland (CBFSAI) has oversight of the clearing systems, although they do not engage in detailed or intensive regulation. Therefore, both Automated Clearing House and truncation technology have the potential to bring significant benefits to clearing in Ireland.

Actions to increase competition The Competition Authority's recommendations are:

- *facilitating new members joining* the payment clearing system: for example, to clarify the status of credit unions;
- *improving corporate governance structure* of the payment system: for example, to create a single Board of directors;
- increasing the *transparency* of the payment system: publishing decisions and actions taken by the Irish Payment Service Organisation (IPSO) Board meeting;
- promoting a *more efficient payment* system: adopting new technology for electronic copies of cheques, updating clearing rules, implementing ACH.

3.2.4 Comments on the Irish report

Information in the reports are adequate and clearly presented. The details given are useful in getting a picture of the overall degree of competition in retail banking in Ireland. Moreover, specific actions to be taken are identified along with the actors to which they are directed at. In particular, the idea of ensuring consumers and SMEs receive their account histories without charge seems valuable. This measure will not only allow consumers to switch more easily, it may also provide banks with an instrument to deal with risk. In addition to making it easier to switch provider and control risks, it will also enhance the level of competition by reducing the informational disadvantage of small banks, making relationship lending a minor concern. In fact, as with the case of credit databases, account (credit) histories will reduce the degree of asymmetric information. However, contrary to credit databases, it forces large banks to even share good information, which they are otherwise not motivated to do. Even small banks could therefore be able to develop a sound risk model since they can (potentially) rely on the same amount of information.

As in other reports, assessing market structure is based on traditional measures only, reflecting a traditional view of the relationship between competition and market structure. Furthermore, even though looking at the national level of concentration makes international comparisons possible, it completely neglects that the retail market dimension in banking is local-regional. Finally, no clear indications have been given about the methodologies applied when determining the sample data, as it could not be disclosed for confidential reasons.

3.3 Competition in the banking sector in the UK

The Office of Fair Trading (OFT) launched a market study for personal current accounts (PCA) in April 2007.[39] The UK market of current accounts is large, with approximately 54 million active accounts, representing a larger revenue for banks than savings and credit cards combined.[40]

To gather evidence, the OFT analysed key data from 16 banks (covering 90% of the PCA market), reviewed a number of bank and price comparisons websites, examined branch leaflets, and commissioned a telephone-based consumer survey. For each provider all the available PCAs were considered. This included the standard free-in-credit accounts, packaged accounts, student accounts, and basic bank accounts. The free-in-credit accounts are the dominant model and, as long as a customer is in credit, it does not imply any direct cost for having the account or for core services (such as cheques and direct debts). Many PCAs allow customers to borrow money by way of an overdraft which can either be arranged or unarranged. Under an arranged overdraft a customer has the right to accumulate balance up to an agreed level. When the consumer goes beyond that limit, or there is an agreement, this additional lending is known as an unarranged overdraft. As these charges turned out to be relevant, an investigation was also launched into the fairness of unauthorised PCA overdraft charges and return item fees under the Unfair Terms in Consumer Contracts Regulations (UTCCRS).

3.3.1 Current Accounts and Related Services

A current account is used by 90% of consumers and the most common account is the "free/in/credit" (75% of total) in which consumers do not gain interest. Many consumers do not know the fees associated with their accounts and three quarters of them do not know the credit interest rate. This result is due to both the lack of transparency of fees and the complexity in determining them. The most relevant effect is that over a fifth of consumers were unaware of insufficient funds on their account. Few consumers monitor the account market to switch to accounts offering better conditions. From the supply side, the aggregate revenue for banks was 8.3 billion pounds in 2006.

The personal current account market appears to be relatively concentrated, with the first five banks covering 80% of the market, and characterised by two categories of competitors: the *established banks* and the *challengers*. The established banks predominantly compete on quality rather than price elements and have maintained a market share in excess of 60%. While there is some evidence that challengers are slowly increasing their market share, there remain important constraints on their ability to gain consumers. The slow progress of challengers is particularly relevant when seen against the relatively

39 OFT (2008), "Personal Current Accounts in the UK," http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf

40 The average revenue per active PCA is £152, of which 50% come from interest income, 31% come from insufficient fund charges, and 6% from net arranged and unarranged overdraft.

attractive credit and overdraft interest rates offered by many challengers. Moreover, there has been no evidence of significant entry.

The main barriers identified in the report are consumer inertia, the importance of establishing a branch network, and the importance of establishing a brand name. A significant feature of the current account market in the UK is the low level of customer switching. Results from the OFT survey indicate that around 6% of account customers had switched in the previous year and 61% of consumers had held their main account for more than 10 years. In the main, customers are quite satisfied with their providers (48% of those who have never switched did not do so because they like their current provider).

The number of branches varies widely between the top 10 banks, with the largest bank having a network 24 times the size of the smallest bank. Telephone and internet banking has complemented traditional bank-based banking instead of replacing it, and according to the OFT survey, 92% of consumers still use in-branch banking at least once a year.

Brand also matters in the current account market. The vast majority of account consumers (83%) said that they were reluctant to leave an existing bank they trust for one they did not know. The OFT believes that the direct consequences of consumers' carelessness and limiting understanding are a reduction in the incentives for banks to compete on less visible elements, such as insufficient fund charges and foregone interests. For insufficient fund charges, this effect is exacerbated by the lack of a simple mechanism that allows customers to control, or opt-out of, an unarranged overdraft. As a consequence, competitive pressures have only reduced core, or day to day, transaction charges to zero.

The OFT concludes that, collectively, these concerns constrain the market's ability to deliver value to a significant proportion of consumers and banks' incentives to provide new and innovative PCA solutions. Moreover, there seems to be significant cross-subsidisation from those consumers who incur insufficient fund charges (socially vulnerable people) to those who do not (higher income and savings people), which may create significant distortions in the market.

Actions to increase competition The OFT has not proposed solutions to increase competition but has identified three main areas where improvements may deliver significant benefits to consumers:

- increasing transparency;
- enhancing the number of active and informed consumers;
- improving the switching process, by minimising barriers to switching and improving consumers' perception of the process.

In order to identify potential remedies, the OFT has launched a consultation with the banking industry, consumer groups and interested parties.

3.3.2 Comments on the British investigation

The report´s outstanding feature is the depth of its investigation of consumers' choices which offers important insights into consumers' attitudes. As in the Italian investigation, the inquiry deserves merit for also having a closer look at the demand side, even though it does not collect information according to different categories of consumers. On the one hand, this analysis cannot help in identifying different degrees of consumers´ risk. On the other hand, however, it allows a behavioural analysis of survey results by a psychologist distinguishing uninformed choices from irrational ones.

In particular, the psychology of current account usage showed that consumers tended to focus on the present more than the future, suggesting that they would have to expect there to be significant future benefits from switching in order for them to be willing to put in the time and effort required to switch in the present. The analysis also showed that consumers are overconfident and underestimate the likelihood of incurring a charge.

Moreover, this report is the only one that tried to explicitly account for the quality of services. However, looking at customer satisfaction is not the right way to capture product quality. As with any other financial product, current account prices must be risk-adjusted: consumers might be willing to pay higher prices (or to accept lower interest) for services from banks that they trust and consider less risky.

Finally, the OFT paid attention to the role of branches. As it is recognized in the report, most customers choose a bank based on where its nearest branch is and only a small minority consider the bank charges. Perhaps the major weakness of this report is the OFT's reticence to identify solutions.

3.4 Competition in Nordic Retail Banking

The overall purpose of this report is to identify common competition problems in retail banking in Denmark, Finland, Iceland, Faroe Islands, Norway and Sweden, focusing on access payment systems and consumer mobility.[41]

The majority of retail banks in Nordic countries are domestically owned and only a few banks dominate the market.[42] The concentration measure CR4 ranges between 71 and 95%, showing a positive trend in the last decade, with the only exception being Sweden. Results are robust to different variables used for computing the concentration index. The measure is above the EU-mean. Profitability measures indicate that Nordic banks are profitable: on average, there is a tendency for the Nordic bank markets to exhibit higher return on assets and high interest margins compared to other European countries. The number of actors and fringe players appears to be growing in most of the markets. Nevertheless, their impact is still modest and some have disappeared through mergers and acquisitions. Only one real exit from the market has occurred (COOP Bank in Sweden in 2003). In all Nordic countries the number of local branches is falling.

3.4.1 Interbank payment systems

The report first focused on the interbank payment systems.[43] Accessibility to that market – on a non discriminatory basis - is necessary to offer and develop customer services. This market is characterized by cooperation among competitors, whereas in the downstream market (the market of payment services), banks compete with each other. The interbank payment systems are either arranged by the banks themselves or by the central bank. The role of the central bank varies somewhat in the different Nordic countries and the interbank retail payment systems are, as a rule, wholly operated and owned by private bodies that consist of banks operating within the market. The influence of the banks is generally channelled through bankers' associations. Banks entering the market have the option of joining the interbank system indirectly, as a client of a bank already in the system.

From the point of view of competition, the report identifies the following problems:

- cooperation among banks in the (interbank) upstream market may lead to informational exchange with regard to practices affecting the competitive conduct in the (consumer) downstream market;
- once a network has been built, it becomes difficult for new competing networks to gain the critical mass necessary to function effectively;
- there could be difficulties for new banks to join existing networks since the systems are governed by banks already operating in the markets;
- conflicts of interests may arise between the two roles of being a customer and an owner at the same time of the services relating to payment infrastructures.

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41 Nordic Competition Authorities (2006), "Competition in Nordic Retail Banking," Tech Rep. available at http://www.kilpailuvirasto.fi/tiedostot/Nordic_Retail_Banking.pdf

42 There are no foreign banks active in Iceland and in the Faroe Islands, but in the other Nordic countries, foreign-owned banks make up a sizeable part of the market. Most of these banks are Scandinavian and have their headquarters in another Nordic country. During recent years, in fact, the large domestic banks have expanded in neighbouring countries. For example, after a series of mergers, Nordea is among the three largest banks in Finland, Sweden, Norway and Denmark.

43 The interbank payment systems refer to the upstream market of the market for payments services (or customer services) and represents the infrastructure which govern banks' own mutual payments.

The report concluded that, fees and access conditions may constitute a form of entry barrier to entry to the payment systems.

Actions to increase competition A transparent entry process is necessary. The joining party needs to have a clear idea in advance of the length of the process and the related costs. In addition, to eliminate the risk of discrimination, it may be necessary to split the management-owner and client roles of payment systems.

3.4.2 Payment card systems

The Nordic competition authorities considered competition problems concerning payment transfer service as mainly connected to access to infrastructure in cash withdrawal card systems and payment card systems.

Infrastructure for cash withdrawal card systems and payment card systems can be based on the infrastructure of a single dominant participant or on bilateral or multilateral arrangements. In any case, it is impossible, or at least very expensive, to create separate infrastructures independently of other market participants. In Norway, Denmark, the Faroe Islands, and Sweden ATMs are owned by the large banks individually. This means that dominance by a single undertaking is unlikely to occur. On the other hand, competitive concerns may arise due to collective dominance or due to horizontal cooperation between banks. In Finland a new competition network would not be economically viable since Automatia - controlled by the three largest banks - dominates ATMs. By measuring the number of withdrawals per ATM, the report indicated that there are relatively large Nordic variations in the number of ATMs. It seems that Sweden and Finland are undersupplied with ATMs compared to other European countries.

Regarding payment cards, there are two predominant systems in the Nordic countries. In Sweden and Iceland, the payment system is based on international payment card systems whereas in Denmark, the Faroe Islands, Norway and Finland, payment card systems are, to a large extent, national joint venture enterprises. The competition authorities reported that in all of the Nordic countries there is little or no cross-border activity in connection with the payment systems. Most of the Nordic countries have a mixture of regulation by law and self-regulation, with primary emphasis on self-regulation. Possible competition concerns seem to be addressed by self-regulators on the request of national competition authorities. For instance, the banking industry in Sweden is, to a high degree, self-regulated. The cash withdrawal card system is not regulated formally and banks that own parts of the ATM infrastructure are expected to provide access using conditions that are not discriminatory. The level of entry seems therefore to depend upon self-regulation.[44]

Actions to increase competition The establishment of rules to ensure access for foreign banks and non-bank institutions seems to be an important means to increase the competitive pressure of payment card systems.

3.4.3 Customer mobility

The report identifies five selected barriers to customer mobility:

- the existence of switching costs;[45]
- the existence of searching costs;
- the difficulties in make comparisons;

[44] Cases: In 2003 the Norwegian competition authority banned an exclusive agreement between (BBS) (the main clearing infrastructure, jointly owned by a number of banks) and the banks regarding the processing of EFTPOS transactions.
In Sweden, the competition authority has noticed that small actors may have problems with the way terms of access to the general payment systems in banking are designed. In particular, volume discounts on total invoice amounts made the discount given to small actors below 5% while the large banks enjoy discounts that are often in the region of 10-30%. Nonetheless the authority recognised that this pricing structure was not optimal from a competition standpoint, it found that the pricing was objectively defendable on efficiency and economies of scale basis.

[45] This is the particularly the case of Norway (i.e, notary fee for mortgage loans)

- bundling;[46]
- transportation costs.

There are only limited empirical data available on customer mobility. In Finland, Iceland and Sweden, no studies have been conducted that look directly at this issue. The Danish competition authority calculates a mobility index each year. Since 2000, the value of the index is substantially below the average of the services sector as a whole. The Norwegian competition authority has calculated the same index for lending to SMEs and found results consistent with the Danish results.
Several of the Nordic competition authorities have the impression that it has become more and more common for customers to have several parallel bank relationships. In general, empirical switching rates show that around 5% of customers switch each year. Compared to other European countries, the banking sector mobility in the Nordic countries appears to be average. Nordic customers seem to be content with their banking relationship. In Denmark a survey showed that 70% of the customers would not consider switching banks even if it could be done without incurring costs. Similar satisfaction can be observed in the other Nordic countries.

Actions to increase competition In order to increase customer mobility, the study proposes the following actions:

- *increase transparency* through, for example, websites where consumers can get accessible and clear information to make informed and rational choices;
- *making the switching process easier* by providing switching facilities to reduce the costs and formulating clear rules in a Switching Code.

3.4.4 Comments on the Nordic Report

The information in the reports is presented in a complex way. The details given are not always useful to gain a real understanding of the competitive situation in the retail banking market, and make it difficult to focus on related problems.

Even in this report, there is the tendency to analyze the evolution of the market structure simply by looking at concentration measures and their evolution over time. On the contrary, in such markets, where there are few and similar banks, interesting insights could arise from an analysis of the relative market shares and the associated empirical measure proposed by Melnik et al. (2005).[47]
Overall, the report concluded that the Nordic retail banking markets are fairly concentrated in comparison with retail banking markets in other countries in Europe. It also stressed the tendency, on average, for the Nordic bank markets to exhibit a higher return on assets and high net interest margins compared to the reference countries (Germany, UK, Netherlands, Ireland, Austria). Despite recognising the cost-to-income ratio as a proxy for efficiency and competitive conditions, the report somehow overlooked that Nordic countries are also more efficient compared to the same reference countries exhibiting lower values for this index.

4 European Competition Policy in the wake of the financial crisis

The recent financial crisis has put European competition policy to test. In particular, in order to overcome the high risk of failure of the largest European banks, which were heavily exposed to CDS and ABS, many Members States have put stability concerns in front of those related to competition by taking actions to directly intervene in the banking system. The depth of the situation forced also the European Commission to follow the same line.

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[46] 19Jul (2006) survey bundling of products turned out to be widespread, 79% of the respondent banks use some sort of loyalty program or customer package

[47] See Melnik, A., Shy, O. and Stenbacka, R. (2005), "Assessing Dominance", *Journal of Economic Behavior and Organization,* 68, 63-72.

In particular, and differently from the various solutions initially proposed (e.g. it was argued either to use BEI funds or convert banks' debt into working capital), many governments directly intervened on banks' capital to avoid default. The Commission has recognized the need for flexible procedures in order to safeguard the stability of the European financial systems in times of crisis. DG Competition intervened with an important document on 25th October 2008 concerning "The application of the State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis", which contained the following requirements:

• non-discriminatory access, i.e. eligibility not based on nationality;
• time-limited state support;
• clear limits on the scale and scope of state support;
• appropriate contributions by the private sector to the costs
• adequate rules to control the behavior of recipients and prevent abuse of state aid, e.g. to limit aggressive market strategies;
• restructuring either for the financial sector as a whole or for individual institutions.

While this and following steps taken by the DG Competition played an important role in ensuring a more coordinated form of crisis management across Europe and in limiting distortions, it clearly appears that the DG Competition was "running after" governments in that it tried to the extent possible to reconcile the stability-oriented interventions of the national governments with European competition policy. Although many of these interventions implied costs for the banks, and were time-limited, many of them were undoubtedly forms of State Aid.

Many amongst academics and professionals are therefore asking how to restore the competitive mechanism and ensure that competition rules are again fully applied after the financial crisis. We believe that it is necessary to reabsorb these aids, and to codify *new procedures* that in the future will allow governments to rapidly intervene without altering the level playing field in the banking sector. In that respect, the measures that the Commission has imposed on some of the banks receiving aids are of crucial importance in order to discourage banks from relying on public intervention in the future. Also, we believe that a deeper understanding of the nexus between competition and stability is still necessary. For instance, when allowing a merger, should competition authorities take into account the costs of creating banks "too big to fail"? How to measure the gains and costs for consumers, both in terms of lower prices and risks? In order to answer such questions, we believe that a *new approach* to assess competition in the banking industry, which takes account of the risk from a stability point of view, has to be developed. As it emerged from the national inquiries surveyed in this paper, the most important aspect of financial transactions together with price, i.e. *risk*, has not been taken into account with the care it deserved. As the crisis unfortunately reminded us, it is not possible to overlook risk issues in the banking industry, and competition authorities should develop the internal skills necessary to operate these adjustments in an appropriate way. Prices and profits which are not appropriately risk-adjusted might not be very informative, and simple comparisons could be seriously misleading.
The crisis has made it harder than usual to assess competition as banks that existed years ago may longer exit. However, as many as argued and we agree, competition policy rather than being an obstacle must be an integral part of the solution.[48]

[48] See the speech mady by Neelie Kroes EU Commissioner for competition policies in defence of competition policy, 13 Ocotober 2008.

5 Conclusions

The way to look at competition in the financial sector has dramatically changed, both in academic and regulatory circles, compared to the decades before the current financial crisis. Up to the nineties, competition in the financial and banking sectors had been considered inimical for stability. Theories of banking regulation suggested that too much competition, by reducing the future value of the banking activities, would induce banks to take excessive risk. As a consequence, limiting competition has long been considered the channel through which financial supervisors might prevent a banking crisis. The 'new view' of competition, which has emerged in the last two decades, instead considers that competition does not necessarily have detrimental effects for stability. The idea is that a higher degree of competition within a well-designed regulatory framework may induce banks to become more prudent and more efficient in allocating financial resources.

At the same time, following the shift in the academic literature and the strengthening of general competition policy, competition authorities have also changed their approaches to banking competition. In many countries, this process of promoting competition among banks culminated in the complete review of mergers and acquisitions in the banking sector by the antitrust authority. In other countries, despite some specificities remaining, since some decision-making power is still shared with other authorities, the banking competition policy strengthened its objectives and became more transparent. As a consequence, various competition authorities throughout Europe, and the European Commission itself, simultaneously launched sector inquiries in order to understand the real competitive situation in this complex, and somehow novel, sector. Then the crisis struck.

The aim of this paper was to summarize these recent inquiries on retail banking, giving comments on the methodologies and perspectives that antitrust authorities have used to analyze competition among banks, and to the degree with which the peculiar features of the financial industry were taken into account.

It is important to stress that, although the inquiries could be improved methodologically in one way or another, they offer a clear picture of retail banking competition in Europe. Moreover, they tend, in general, to agree with the academic literature on what seems to be the main current competition concerns. In particular, the inquiries have emphasized the presence of switching costs. These costs, which make it costly for consumers to change bank and consequently more difficult for a new bank to acquire new clients, characterize all European banking systems. When they are not justified by effective costs sustained by banks, switching costs require a careful intervention of the regulator. In Ireland, for example, anti-money laundering requirements make it easier for banks with extensive branches to compete for new customers. An intervention that creates standard procedures for transferring and accepting personal identity information will lower the cost of switching banks. The Italian competition authority and the European Commission also stressed the practice of tying. By reducing transparency and discouraging entry of new players (especially mono-line suppliers), tying may weaken retail banking competition and further increase switching costs.

Despite recognizing the relevance of switching costs, none of the inquiries made an attempt to estimate the cost of switching banks nor investigated the cost of obtaining greater transparency. On the one hand, it is somewhat obvious that eliminating tying makes it easier for consumers to compare the prices of different products across different banks. On the other hand, however, it is not clear how it will impact on banks' costs, for example, in terms of lending procedures or investments in information technology.

Furthermore, it appears that some other possibly relevant issues, in terms of competition analysis, have not been considered in the inquiries. For example, costs should be disaggregated in relation to bank size and type, since many of the results seem to be driven by the selection of larger banks in the sample. A deeper look into bank efficiency also appears necessary. For example, better productivity-adjusted measures may be employed. In this perspective, the price differences in products offered by foreign banks is an important issue deserving more investigation. There is evidence that foreign banks, entering either by takeover or greenfield, introduce more efficiency in the market and more favorable conditions for clients. Taxation is another important issue to control for. All of the reports have investigated bank costs. These costs may not reflect the true cost - including taxes - effectively borne by the consumers.

Finally, from the point of view of considering the peculiarities of the financial intermediation industry, we found that the approaches used in the reports are not sufficiently complete, and probably insufficient to overcome the attempts spurred by the current crisis, to again reduce the exposure of the financial industry to competition policy. First, most of these inquiries have not considered the most important aspect of financial transactions together with price, i.e., risk, with sufficient care. Variables like prices and costs are mostly taken as they are, when they should all be risk-adjusted. Risk considerations are central for the financial industry, as risk is the most important qualitative aspect of financial transactions. Moreover, we know that changes in price tend to affect the riskiness of financial assets, so that "quality depends on price" in this industry.

Therefore, especially for financial products, it is not possible to overlook quality/risk issues, and competition authorities should develop the internal skills necessary to operate these adjustments in an appropriate way. Prices which are not appropriately risk-adjusted might not be very informative and simple comparisons could be seriously misleading.

Second, and in relation, much still needs to be learnt about the relationship between competition and stability. For example, the recent sub-prime crisis has also been attributed, by some observers, to an excess of competition among banks in the mortgage segment, along with poor supervision and regulation. These opinions are not unique. However, it is obvious that in periods of high volatility, a clear understanding of the nexus between competition and stability appears to be even more crucial, and this link should at least be present in the mind of competition authorities when dealing with the banking industry.

This last point inevitably leads to the question of the role of competition authorities. Should competition authorities simply look at competition issues or should they also consider stability concerns? And if so, in what way? Despite having the task of promoting competition, it is not clear that having the competition authorities solely focusing on this task is the right approach. In addition, the consequences of competition policy on bank stability are anything but clear. For instance, when allowing a merger, should competition authorities take the costs of the creation of banks that are ‘too big to fail’ into account? The answers to these questions seem to be points of interest for future research.