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The Commission's Retail Banking Inquiry: A Chance for More Competition

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The European Commission's in-depth inquiry into retail banking is long overdue. Its findings are hardly surprising: for years high fees persisted, market concentration loomed and there was little cross-border competition. Unfortunately, European consumers and small businesses became used to it, but times could now be changing for the better. DG Competition states that it has found "widespread competition barriers" that raise the cost of retail banking, but "competition concerns" are not evidence of breaches of competition law. The Commission must now prove that its claims are not unfounded: the next steps are investigation and prosecution of individual cases. The industry, on the other hand, must address the concerns of the Commission through a critical assessment of its business practices and through voluntary reforms if necessary. More competition in retail banking services is only beneficial: it will lead to improved service quality, lower prices and larger savings in the European Union. The inquiry should be seen as chance for increasing competition.

The European Commission has directed harsh criticism at the retail banking industry in Europe: in its final "Report on the retail banking sector inquiry", it finds major competition barriers, restrictions and distortions in the common market for retail banking services. Retail banking encompasses savings, borrowing and payment services for consumers and small businesses. In its inquiry, the Commission has examined the markets for payment cards and systems as well as the market for current accounts and related services. Such sector inquiries aim to identify whether there are sufficient grounds to investigate possible anti-competitive practices by the industry. If this is the case and evidence of breaches of national or EU competition law are found, the business practices or arrangements can be addressed by anti-trust action. Sector inquiries are the first step in the full-scale enforcement of anti-trust law. They are also a tool to spark voluntary changes in the industry.

THE PRIMARY FINDINGS: THE PRICE IS TOO HIGH

The Commission has several concerns regarding payment cards and payment systems, which generate an estimated overall value of €1.350 billion a year,. One concern is high concentration as measured by the Herfindahl-Hirschman Index. For this index, market shares of companies are squared and added, with results below 2,000 usually not raising competition concerns. However, the level of concentration in the acquisition of cards is well above 5,000 in many European markets (such as PT, FI and DK). Cards issuing, on the other hand, is not seen as concentrated. The Commission has voiced further concerns with regard to large variations in merchant and interchange fees, high profitability and divergent technical standards.

In the current account and related services inquiry (generating €250-275 billion in gross income per year), it found a concentration above 70% based on retail income in the 3 or 5 largest players (so-called CR-3 and CR-5 ratios) in several countries (FI, NL, BE and SE). Profits before taxes are over 30% in some countries (IE, ES, FI and SE). The Commission observed that cooperation among banks and credit registers might be used as market entry barriers. In addition, there is evidence of product tying and introducing obstacles to consumer mobility. Taken together, these factors limit competition and fragment markets along national borders, unnecessarily raising the cost of retail banking for consumers.

Is it possible that this situation will change soon? Retail banking (excluding credit cards) has – to a great extent – always been local or regional – even in markets such as the US, where consumers tend to cluster products and services they use at one bank and only switch banks (or accounts) when they move. In Europe, cross-border lending to consumers and small companies is minimal: there is simply at present no interest, in such services on the part of banks or consumers. There are explanations from behavioural economics for little consumer action, namely that human attention is limited and rationality is bounded. Therefore, the attention span devoted to screening and comparing of retail banking products is limited. For instance, one can hardly expect consumers to screen all *national credit advertisements* for the best price. Why would they bother to screen *international ones?* It is sometimes fairly difficult to discern whether it is the suppliers' behaviour or general market conditions (such as certain demand-side features) that limit competition. The Commission must now prove that banks willingly and systematically breach competition law such as Arts. 81 and 82. Art. 81 prohibits price fixing, control of production, territorial market division and tying (bundling), Art. 82 prohibits the abuse of a dominant position. National competition authorities are now asked to help to investigate cases that might warrant further action. And the Commission has made it clear that it will make "full use" of its power to tackle the barriers.

THE PRICE IS TOO HIGH: WHAT'S CAUSE AND EFFECT?

DG Competition monitors and analyses the usual suspects: market concentration and performance (prices, fees and profitability), bundling or tying, etc. Simple economic theory teaches that if prices are above short-term marginal costs, profits are 'too high' or at least higher than in competitive environments. Market structure – most simply the number of competitors – influences market performance through price-setting behaviour of companies. The problem is that the direction of effect is not always clear: most measures for market structure are not what economists call an *exogenous* variable: profits and market structure interact and the direction of effect is not always clear. This is the so-called 'endogeneity' problem, which can only be solved by looking at longer time series and applying more complicated statistical analysis. The type of advanced analysis that might shed more light on the very issues criticised by the Commission is not what one finds by looking at the Commission's report. There are some regressions in the chapter on consumer mobility, but results are weak and provide only a snapshot. Relations between profitability, market structure and market conduct are complicated and a descriptive analysis is not sufficient to draw final conclusions. In that sense, the Commission must improve the techniques applied for inquiries so that the analysis becomes truly analytical and does not remain on the descriptive level paired with random ad hoc descriptions of individual cases.

In addition, there are other factors that influence market performance; such as technology and demand-side conditions. The problem with criticising prices in markets is that one must know better, or, in other words, *which price is right*? Markets are never perfect; however, some might be more imperfect than others. The usual suspects of market failure are: ‘natural’ monopolies, public goods, externalities or information asymmetries. The latter two are especially important in banking. Externalities explain concentration in network markets, or simply put: the bigger the net, the better as this has scale effects. Information asymmetries explain that banks do not have a complete picture about a borrower’s risk. Therefore, they must use credit registers in which they share information about consumers. This industry – credit bureaus – has for too long operated under the radar of competition authorities. It is time for an in-depth study of how registers can be used for erecting informational market barriers, what are the competition conditions in the industry and whether there is evidence of strategic incomplete information-sharing.

The retail sector inquiry can only address business practices of the industry. Without diminishing the importance of that focus, one must also discuss the role of government or consumers. Only by looking from a bird’s eye perspective can the whole picture emerge, although this cannot be addressed by a retail sector inquiry. For instance, national governments are in charge of dismantling legal obstacles for cross-border transactions.

European competition authorities must ask themselves if the enforcement of competition policy was not too lax in the past. High market concentration, lock-in and product bundling allow companies to shift economic rents accruing from the transaction to the disadvantage of consumers. This, however, is nothing new. Maybe there should have been a thorough analysis of the technical and informational structure in retail banking as well as harsher enforcement of anti-trust law on national level.

The Commission’s action is long overdue and must be welcomed. But this is just a first step, and accusations make no proof. DG Competition and national competition authorities must now live up to the claims and prove by whom, how and where competition law was infringed. These breaches should in fact be prosecuted with full force. The future direction should, however, focus on market entry and exit barriers (and less on the number of competitors) and on a harmonisation of technical standards. Reduced market barriers, harmonised standards and fair but efficient enforcement of competition law will contribute to intensified competition in retail banking in Europe.

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