RETAIL BANKING SECTOR INQUIRY
PRELIMINARY REPORT II
CONSULTATION FEEDBACK FORM

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Have you received a request for information as part of the sector inquiry:

□ Yes

■ No

General Remarks

The „Interim Report II: Current Accounts and Related Services" (IR II) undertakes a major effort at collecting data about the European retail banking industry. For many years to come IR II will provide a major source of reference to analysts working in this field. Unfortunately, the analytical results do not quite match the data collection effort. Partly this is due to a much greater awareness of the Commission as compared to the "Interim Report I Payment Cards" about the many analytical pitfalls afflicting the analysis of a complex industry in a cross-country framework.[1] But partly this scarcity of results is due to a lack of analytical focus. There is no conclusive evidence provided in IR II about whether competition problems exist in European retail banking and what policy measures would be most effective at addressing any such problems.

- *Non-regulatory factors are important for explaining national fragmentation.*

A major finding of IR II is the high degree of fragmentation in European retail banking. Unlike in other industries the economic forces integrating formerly separated national markets do not seem to have taken root in retail banking. Even major policy initiatives such as the creation of the internal market and the common currency as well as many other EU regulatory reforms targeted at reducing specific institutional barriers between national banking markets have only modestly reduced the degree of actually existing fragmentation. The relative ineffectiveness of these past regulatory projects suggests that other economic factors being less amenable to policy are important for fragmentation. In this case more regulation would just bear the risk of creating more bureaucracy rather than integrating markets and may even further increase segmentation.

- *The complexity of assessing and managing retail credit risk is a key factor explaining fragmentation.*

As an analytical starting point we suggest to look at some fundamental economic factors in the banking industry. In recent years banking research and banking regulation (e.g., Basel II) have stressed the importance of customers' creditworthiness in informationally opaque banking markets. Credit risk is key for the retail loan business and for payment services alike.

[1] If the same level of care were applied in the empirical analysis of Interim Report I, several of the major results obtained there could not be upheld.

Banks are better at assessing the ability of borrowers to repay debt and they can efficiently renegotiate and enforce contracts when such borrowers come under financial stress. The development of long-term relationships between banks and their customers is an important factor for efficiently dealing with issues of creditworthiness because over time agents can acquire knowledge, build up reputation, and improve incentives to fulfill contractual obligations by making future benefits dependent upon compliance. Also assessment costs can be spread over longer time periods.

- *Assessing and managing credit risk in retail banking requires local knowledge.*

The assessment of the ability of retail borrowers to repay and the renegotiation and enforcement of contracts requires first-hand knowledge of the specific economic, institutional, and cultural circumstances under which a borrower operates. For typical retail customers local and national factors will matter most. Hence a smoothly functioning retail loan and retail payments business requires some form of geographical proximity with customers. Also a high correlation of local credit risks in the loan portfolio of the bank makes the assessment and awareness of credit risks easier at the local level.

- *If banks conduct cross-border retail business on a larger scale they typically opt for mergers or takeovers which have less impact on reducing fragmentation, however.*

Direct cross-border banking will not occur on a larger scale because typically a bank lacks the knowledge necessary to assess creditworthiness and to negotiate contracts in some other country. Banks can either establish de novo institutions or they can link up with already existing banks by merging or taking them over in order to gain the local presence which is key in retail banking. De novo institutions are usually deemed to be costly solutions because new banks have to invest large sums into building up infrastructure, acquiring knowledge, and developing customer relationships which puts them at a competitive disadvantage vis à vis incumbent banks. Also profit opportunities are limited in the mature EU retail banking markets. Hence if a bank has some reason to conduct retail banking across borders, it typically chooses to merge with or take over another bank, inheriting existing branch networks and established long-term customer relationships. However, cross-border mergers or takeovers in a mature market have the least impact on fragmentation and competition because the number of competitiors in the market does not increase and local business practices will tend to get perpetuated.

- *Retail investors exhibit a clear preference for local financial service providers.*

Trust in the ability of a financial institution to repay is also a major issue for investors, particularly if they are less financially sophisticated. Often this will also require a repeated personal exchange and exclude financial service providers other than local ones. Thereby national fragmentation tends to get perpetuated.

- *If the importance of local factors for assessing and managing credit risk is relatively independent from EU regulation, the impact of further EU policy initiatives will remain modest.*

Retail banking appears to be a field where the limits of integrating national markets become visible. Despite a long string of major regulatory changes in the past national fragmentation has not much been affected. One should be very careful to arrive at the conclusion that ever more rounds of new regulations and harmonisations are needed. If factors independent from regulation such as the importance of local factors for assessing and managing retail credit risk mainly cause fragmentation, the impact of further regulatory reforms will remain modest. It still may make sense to develop a more unified EU regulatory framework in the long term, but shorter-term policies building upon exaggerated expectations will be inefficient and can incur a high cost for society.

General questions:

A. Market structure and fragmentation

1. *What are the main reasons for market fragmentation in Europe's retail banking sector? Please identify whether they are mainly of regulatory, structural or behavioural nature.*

Whereas regulatory factors may have some role, the moderate response of the banking industry to past regulatory changes suggests that structural and behavioural factors play a major role. Assessing the creditworthiness of retail banking customers and negotiating and enforcing contracts requires a great deal of local knowledge. For many banks building up the business structures supporting the acquisition of such knowledge in a mature market of another country is not worth the cost. Also many retail investors have a preference for local providers offering some form of personal interaction.

2. *What are the main causes and implications of the different level of concentration in the EU retail banking markets?*

A large number of different, often nation-specific factors affect concentration. Hence it is hard to generalize and to develop broad policy measures at the EU level.

B. Banks' financial performance and pricing

3. *What are the main reasons for the varying rates of profitability and income in retail banking across the Member States?*

First, there is a data issue. It is inherently difficult to allocate costs and revenues in complex multiproduct firms such as banks. This problem gets further aggravated if no uniform methods for defining retail banking and calculating profits are applied. Second, when looking at pre-tax profits additional variation between countries is obtained if different tax rates exist. Third, the profit measures considered in the Interim Report are rough indicators at best. To assess the appropriateness of profits generally accepted accounting procedures consider returns as related to the capital employed, the risk involved and the returns to be obtained from alternative investments. Fourth, when profitability or income are related to another economic variable, it is important to control for the influence of other factors. Otherwise additional variation is obtained and conclusions from studying bivariate relationships may be misleading.

C. Entry barriers in retail banking

4. Are there other types of entry barriers in retail banking that have not been identified in the preliminary report?

The local character of assessing and managing retail credit risk has not been adequately considered although it has far-reaching consequences for the geographical structure of retail banking (see the general remarks at the beginning of this document).

5. *Where and how does competition law have a role in tackling barriers to entry in retail banking?*

The Interim Report II does not provide hard evidence that abuses of competition create major entry barriers. The existing barriers appear to be structural and behavioural in nature rather than being the direct consequence of inappropriate conduct by banks. This implies a limited scope for authorities to change market outcomes through policy.

6. *Access to credit databases and payment infrastructures are sometimes cited as a barrier to entry in retail banking markets. Are there significant barriers to access which merit further investigation?*

It may be the case that in some countries some currently existing access rules to databases or payment structures do not promote cross-border activity in retail banking. However, policy measures targeted at relaxing these rules are unlikely to significantly alter the degree of fragmentation in retail banking because other major economic factors still impede the process. Today, fragmentation continues to exist even in those countries where there are no such barriers already now.

D. Customer choice and mobility

7. *What are the main reasons for the low mobility of retail banking customers?*

Mobility per se, e.g. measured as churn is not a reliable indicator of the strength of customers' responses towards price increases as it remains unclear to which degree switching unrelated to price signals occurs. The price elasticity of demand provides a more accurate, economically meaningful measure. It also remains unclear which degree of churn or longevity is considered to be low, high or normal. E.g., if a bank with a relatively large market share of 20% in the deposit market faces a churn value of 0.1 this will mean that the bank loses about a quarter of its customers (assuming that the new accounts opened at other banks also are reflected in the churn value). This does not seem to be a particularly weak reaction although according to the Report this value would be considered as low.

As argued in the general remarks above, long-term relationships are key for solving fundamental incentive problems due to asymmetric information problems in banking. Accordingly this should reduce the willingness of customers to switch between banks. Because in those long-term relationships additional value is created, it is not surprising that a higher longevity of current accounts is correlated with higher profits. Hence one should be careful to interpret this finding as an indication of supernormal profits due to limited switching of bank customers.

E. Development of payment infrastructures in the context of the Single Euro Payment Area

8. *Are there features of the payment industry that limit competition either at the level of provision of clearing and settlement services or the provision of retail banking services? Please indicate areas that merit further investigation.*

We agree with the Interim Report II that network effects and economies of scale are key for explaining concentration in payment markets. The real challenge is to develop further the concepts of regulatory competition analysis to properly take into account the specific economic features of such industries. Particularly networks require an analytical framework being different from conventional markets. Regulators have failed so far to come up with such innovative concepts. Rather they apply ideas from conventional markets to network industries which leads to erroneous conclusions and inappropriate policy measures.

9. Are interchange fees necessary for the development of payment instruments (credit transfers and direct debits) in the EU?

Interchange fees can have an important role for establishing a better economic balance between different parties in a network. Hence they should not be forbidden per se. In order to assess the adequate levels of interchange fees, new innovative regulatory concepts are needed. The currently dominant fee-for-service approach can lead to highly inefficient regulatory outcomes.

10. *Are there issues related to industry initiatives in the context of SEPA that should be assessed form a competition view point?*

If the SEPA process is really going to develop as expected by the European Commission, major parts of both Interim Report I and Interim Report II are almost pointless because a new era of cross-border competition is about to begin in the near future. The analyses of the Reports concerning the structures of the past remain relevant, however, to the degree SEPA fails.

F. Other issues

11. *Please provide comments on any other competition-related issues in relation to retail banking markets.*

The Commission requires a more solid analytical approach to detect behaviour restraining competition in retail banking. So far neither Interim Report I nor Interim Report II make a convincing case demonstrating competitive restraints in retail banking and payment cards systems. One major step would be to develop an analytically sound framework for analyzing competition in a cross-country framework. The current practice of looking mainly at bivariate correlations is insufficient. No firm conclusions can be drawn from such a setup. Also a more unified approach for defining and collecting data is needed. Furthermore new regulatory concepts for analyzing network industries are required as currently existing ones inadequately take into account the specific features of such systems.

Retail banking appears to be a field where the limits of integrating national markets become visible. Despite a long string of major regulatory changes in the past national fragmentation has hardly been affected. One should be very careful to arrive at the conclusion that ever more rounds of new regulations and harmonisations are needed. If factors independent from regulation mainly cause fragmentation, the impact of further regulatory reforms will remain modest. It still may make sense to develop a more unified regulatory framework in the long term, but policies building upon exaggerated expectations can be inefficient and incur a high cost for society.

General questions:

1. Did you find the content of the report easily accessible and understandable?
   - ☐ yes, fully;
   - ■ the report was too general;
   - ☐ the report was too technical.

2. Did you find that the level of detail in the report was:
   - ☐ about right;
   - ■ not sufficiently detailed;
   - ☐ too detailed.

3. Did the information contained in the report was:
   - ☐ generally new to you/the retail banking industry;
   - ☐ mostly known to you/the retail banking industry.

4. Did the market analysis in the report:
   - ☐ confirm your views on the operation of the retail banking market;
   - ☐ challenge your/industry’s views on the operation of the retail banking market;
   - ■ represent a mix of both aspects.

5. Did the report raise the right policy issues;
   - ☐ yes, covered most of the key issues;
   - ■ no, there were some significant issues left out.