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The CC's Northern Ireland Banking Market Investigation – an absence of effective regulation?

The UK Enterprise Act introduced the market investigation, a new instrument that allows the Competition Commission (CC) to analyse markets in which there is "an absence of effective competition" and, where applicable, to implement remedies.[1] The market investigation powers have been trumpeted as a device that will enable the competition authorities to fix problems and benefit consumers in areas that could not easily be reached by the mainstream competition laws against abuse of dominance and restrictive agreements.[2]

This Brief takes a critical look at the CC's market investigation into banking in Northern Ireland. We assess whether the investigation has identified a worthwhile gap in normal competition provisions, and whether adopting the concepts and language of mainstream competition law in such investigations adds or detracts from the clarity of policy in this area.

Background to the investigation

The investigation was prompted by a complaint from the UK Consumers Association, which asserted that the market for personal current accounts (PCAs) in Northern Ireland offered consumers "little choice and poor products". The complaint also suggested a degree of collusion between the main banks in their PCA offerings – "the market is remarkably static and displays a striking degree of similarity in terms of structure and size of bank charges".

In Northern Ireland PCA services are provided through the established branch networks of four main banks (the "clearers"), and a collection of at least five smaller players (the "non-clearers").[3] The concerns were motivated by the fact that, in contrast to the rest of the UK, the traditional clearing banks in Northern Ireland charged per-transaction fees even to PCA customers whose accounts were in credit.

The CC's findings

The CC found that whereas in November 2005 more than half of Northern Ireland's PCA customers were on traditional PCAs, by the end of the investigation in 2007 this figure had fallen to under 20%. This shift was explained partly by the non-clearers winning market share from the clearers. Two of the clearers, Northern and First Trust, had lost 14 percentage share points between them over the latest 7-year period.[4] The clearers had also responded to the competitive pressures and share gains enjoyed by the non-clearers by introducing their own fee-free PCAs. This evidence provided no support for the original concern that the market was "remarkably static". By the standards of banking markets, these changes are positively rapid.[5]

On the basis of HHIs in the range 1,400 to 1,650 the CC concluded that "all measures show the market in 2005 to be concentrated".[6] It also concluded that entry barriers were "high" on the grounds that no recent entry had taken place, and that entry barriers were generated by "a lack of willingness to switch among customers".[7] However, it is hard to imagine that concentration levels are inherently problematic in a small market that already has 8 or 9 suppliers, each with its own branch network, and the CC did not suggest that there is any need for new entrants to make the market more competitive.

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Market investigations are carried out under Section 131 of the UK Enterprise Act, 2002. References to the CC are made by the UK's OFT. Although the market investigation powers are new, this instrument is not wholly different from the old "complex monopoly" powers that existed for many years under the former UK regime.

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Similar motivations appear to lie behind sector inquiries conducted by DG COMP pursuant to Article 17 of Regulation (EC) No 1/2003.

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The clearers comprised the two main Irish banks, BOI and AIB, plus Ulster Bank (a subsidiary of Royal Bank of Scotland) and Northern (now a subsidiary of Danske Bank). The main non-clearers are Halifax, Abbey, Nationwide and Alliance & Leicester.

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CC report, para 4.19.

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At para 4.39, the CC report notes that the decline of the clearers, and the growth of the non-clearers, has been more rapid in Northern Ireland than in Great Britain, which indicates that the market has worked to punish the less competitive offerings of the Northern Ireland clearing banks.

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CC report summary, para 15.

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CC report, para 4.107.

"Unilateral effects"

The CC then went on to look at what it described as "unilateral effects" (a term normally reserved for the analysis of horizontal mergers). Interestingly the CC found no evidence that banks charged prices significantly in excess of the competitive level. There was even some evidence that PCA business had been a loss-making activity for several of the banks.[8]

8 CC report, para 4.332.

The CC nevertheless concluded that banks enjoyed "unilateral power" on the *a priori* grounds that they would be expected to take advantage of customer switching costs by raising prices above those that "would otherwise apply." Its conclusion that there is an absence of effective competition rests on a view that banks enjoy market power over their locked in consumers and that prices "must" therefore be higher than they would be if switching was easier.[9]

9 CC report, para 4.287.

Although the conclusion that profit-seeking suppliers will exploit consumers who face high switching costs sounds intuitive, it is at best only part of the story. Switching costs and imperfect consumer information often impact on *how* suppliers compete, for example leading to intense competition and "loss leader" prices on aspects that are visible to consumers but high margins on aspects that are hidden from them. But these phenomena do not justify a blanket *a priori* conclusion that the overall intensity of competition is any less in such markets.

"Coordinated effects"

The CC rejected the Consumers Association complaint that the main banks were acting in a tacitly collusive manner, but on the grounds that there was so little competition between the banks in the first place that there would be no need for coordination of competitive behaviour:

> *"the conditions for sustained coordination in the market were not met, principally because the clearers do not have an incentive to coordinate due to the low propensity of consumers to switch between banks"* (para 4.306)

Having drawn this conclusion, the CC did not feel it necessary to reach definitive conclusions on the other items on the coordinated effects check list. There is, however, a very strong indication that coordination between the clearers was unstable because of the way in which non-clearers had gained share at the expense of the clearers, particularly in view of the evidence that the clearers themselves had reacted to this external influence by changing their PCA business models extensively.[10] Such evidence provides a more compelling reason to reject coordination concerns, and calls into question the validity of the CC's reasons for doing so.

10 CC report, para 4.303.

Switching costs and consumer behaviour

Assessment of consumer behaviour in the PCA market was central to the investigation. The CC found that consumers were "indifferent" about PCAs as a product and showed very little interest in switching providers.[11] But if consumers are indifferent about PCAs, only a paternalistic approach can explain why intervention would be justified – the CC believed it knows better than consumers what is best for them.

11 Churn rates were around 4-5% per annum, though there was sufficient switching in the market to have led to the recent changes in market shares.

This paternalism even extends to a dismissal of the CC's own evidence on consumers' views. A MORI consumer research study conducted for the CC found that 89% of respondents were "fairly satisfied" or "very satisfied" with their PCAs, but the CC dismissed this evidence, simply asserting that these responses were unreliable due to "an absence of informed customers".[12] This contrasts with the reliance that the CC generally places on such research. It might be possible to justify this paternalistic attitude in terms of some of the recent economic literature on behavioural economics, which analyses market failures that can result when consumers are faced with uncertainty,

12 Para 4.255

information gaps and/or levels of complexity that are too hard to process.[13] However, there is no explicit reference to any such theories in the CC report, and – more seriously – no clear description of how regulatory intervention would overcome any market failure such theories might identify.

The CC was convinced that consumers exaggerated the costs and risks associated with switching. However, a more straightforward explanation for low switching levels in PCAs is that consumers are broadly content with the service they receive and feel that the costs (including the hassle) of changing provider outweigh the likely benefits.

The CC's assessment is almost silent on the incentive that competing suppliers have to overcome consumer switching costs in order to win new business. In markets where switching costs allow suppliers to earn high margins, it is often worthwhile for rival suppliers to offer incentives and undertake marketing activities to persuade consumers to make the switch. The CC noted instances where the non-clearers had offered cash and other incentives to encourage new PCA customers, but did not explain why these *market-determined* initiatives to generate switching were either inferior or less likely to succeed than the *government-determined* initiatives that comprised the remedy package.

PCA banking charges and transparency

The CC was also critical of the way PCA charges were levied.[14] It found that charges were unduly complex, and that banks do not do enough to communicate them to consumers. The greatest criticism of lack of transparency is focused on charges for unauthorised overdrafts, which comprise a high share of PCA revenues for the banks. The CC noted that these charges are not visible to consumers, largely because consumers generally do not plan to overdraw their accounts without approval, or take account of the costs of doing so.

In some respects, the problems that the CC found with the complexity and lack of transparency in charges had increased with the trend towards *greater* competition in the PCA market.[15] The CC found that the (problematic) unauthorised overdraft charges tend to be higher for fee-free PCAs than for traditional PCAs, as providers of fee-free PCAs tended to claw back some revenues by imposing more aggressive penalty charges.[16]

Too much competition?

The CC's finding of an "absence of effective competition" was based on the undue complexity in charging structures, the lack of transparency on bank charges, and the fact that customers do not actively search for alternatives. Significantly, none of these features reflects a conventional failure of competition based on the exercise of market power.

Indeed, the problems identified by the CC have increased as the market has become more competitive. As competition has become fiercer, banks have had to work harder to find ways to achieve a sustainable commercial return. This competitive development has led to higher prices on a smaller number of less visible elements to the PCA, and to less transparency in the market generally.[17] The minority of consumers who incur these hidden charges may have been made worse off by competition even if the majority have gained from the more competitive environment.

In short, an investigation that was motivated by the accusation that the traditional PCAs were bad value for money focused instead on a criticism of the complexity and lack of transparency in the charges levied on PCA customers. All the banks were deemed guilty on this charge, but the problems have become more acute as a result of the influence of competition from the very banks – the non-clearers – who had done most to challenge the traditional PCA and introduce better value products into the market.

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Though the growing literature on bounded rationality indicates that making some consumers more informed does not always benefit consumer surplus. See, for example, Garrod, L. (2007) "Price Transparency and Consumer Naivety in a Competitive Market," CCP Working Paper 07-10.

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See paras 4.109 to 4.186.

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Figure 7 on page 84 of the CC report describes the array of new products and product variations initiated by the clearers during the two years over which the inquiry took place.

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See, for example, para 4.286, where the CC notes "charges will ... in the revised [i.e. fee-free] models be focused on a smaller group of customers who run unauthorised overdrafts, rather than a larger number of customers who run authorised or unauthorised overdrafts."

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See, for example, para 4.276: "banks have chosen their charging structures to reflect the characteristics of the market and the way customers behave. We found that bank charges are being rebalanced towards charges (for example unauthorized overdraft charges) that are less visible to customers and so banks may be able to attract customers despite such charges."

Remedies

In common with a number of previous market investigations, the CC's main remedies were focused on improving the information available to consumers. The CC suggested six separate remedies to clarify and remind consumers of the way they would be charged for transactions on their PCAs.

The seventh, and more interventionist, remedy was an Order designed to encourage more switching in the PCA market. The CC required banks to offer an interest-free overdraft facility (or a blanket commitment to refund bank charges) when accepting new customers who switched PCAs from other banks. This remedy is motivated by the CC's belief that the tendency of customers to exaggerate the costs of switching should be counteracted by a subsidy from the recipient bank to underwrite the risk.

It remains unclear why this remedy is required, or why it should succeed where the market has failed. If consumers' fears of the difficulties of switching are perceived rather than real, the cost of a remedy that forces recipient banks to underwrite the costs of switching should be minimal. But in that case one might ask why the banks had not already introduced such provisions themselves.[18]

Assessment and conclusions

The stated aims of the UK market inquiry regime are "to investigate 'features of markets' that … might lead to an 'adverse effect on competition'".[19] In contrast to the prohibition-based system of the mainstream competition rules, the market inquiry regime "is forward looking, and has as its goal the task of transforming a particular market (if it needs transformation) into one which is, and will continue to be, more competitive than it has been in the past."[20]

In the Northern Ireland banking inquiry, the CC believed that transparency and switching remedies would be beneficial for consumers, but it needed a competition remit to intervene. The CC would presumably argue that the transparency and switching remedies met the competition test by making the provision of PCAs in Northern Ireland *more competitive*. However, if this is the justification for a paternalistic intervention in a market where consumers claim to be satisfied, where incumbent firms are losing share to a growing fringe and where, if anything, more competition has led to more complex services, the CC must surely do more to answer some difficult questions. What, precisely, is the competition failure that requires an Order to force banks to subsidise consumers who switch to their product? Why do normal commercial incentives to win new business not suffice to provide such incentives? And what evidence is there that the CC's intervention will resolve that competition failure in a way that improves consumer welfare?

Until the market investigations regime can provide better answers to these questions, we remain sceptical as to whether in its current form it provides an efficient instrument for making markets work better for consumers. Whilst information problems may be serious in their impact on consumer welfare, and might be partly resolved by government intervention, this does not justify attempts to portray such problems as *competition concerns* when no such concerns exists. To do so confuses the concepts and language of mainstream competition law and thereby detracts from the clarity of policy.

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These incentives would be even stronger if the CC was right in its assumption that an absence of effective competition in the market has allowed banks to change supra-competitive prices to locked in PCA customers. It is also generally acknowledged that capturing a PCA customer increases the likelihood of a bank selling other follow-on products to that customer.

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"The UK Market Inquiry Regime", Professor Paul A Geroski, Paper presented to the Fordham Corporate Law Institute, 7-8 October 2004, page 2.

20

Op cit, page 5.