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Switching Costs and Merger Assessment – don't move the goalposts

In July 2001, the UK Competition Commission (CC) issued its recommendation to block the proposed merger between the two banks, Lloyds TSB Group and Abbey National.[1] Although Abbey National accounted for just 5% of the market for personal banking, the post-merger entity, together with Barclays, HSBC and Royal Bank of Scotland, would have accounted for some 77% of this market in the UK. The CC concluded that this would create a position of collective dominance. In motivating its decision, the CC emphasised the fact that customers perceive switching between banks as a difficult process, and that the actual rate of switching is very low.

This Brief analyses the effect that switching costs have on the appraisal of mergers. Too often, the existence of switching costs is cited as a reason for prohibiting mergers at lower levels of market concentration than would normally be justified. The real impact of switching costs, however, is rather more complex, and can lead to some surprising results.

1 Lloyds TSB Group plc and Abbey National plc – A report on the proposed merger. Competition Commission, July 2001.

Effects of Switching Costs on Competition

Switching costs arise where customers who have purchased from one supplier face real or perceived costs when switching to a rival's product, even if the two firms' products are functionally identical. Switching costs are potentially significant in markets characterised by high information or transaction costs, and they are most important where these costs give rise to long-term relationships and repeated transactions. Such relationships have been cited as important in service industries such as utilities, insurance and banking.[2]

Recent economic research has addressed the impact of switching costs on pricing and competition. One of the key papers in this area describes a model in which each firm must in every period balance the incentive to charge a high price to exploit its locked-in customers, against the incentive to set a low price to attract new customers that build up the firm's current market share and thereby increase future profits.[3] In this model, the incentive to exploit current customers generally dominates the incentive to win new customers, leading to a prediction of higher prices when switching costs are present. As firms value current profits more than future profits, they will generally give a lower priority to the desire to attract new customers relative to the desire to exploit current customers.

A second interesting result presented in the literature is that, in the presence of switching costs, a firm with a lower market share generally has an incentive to price more aggressively than a firm with a large market share. Small firms do not have a large base of infra-marginal customers to worry about when competing for new business, and, for this reason, they can afford to be more aggressive in their pricing policies than the leading players.

It would, however, be simplistic to rely on such results to justify a general prediction that markets in which customers face switching costs are less competitive. Indeed, in a dynamic setting the contest to win the right to supply locked-in customers can be all the more intense because of the benefits that those switching costs confer on suppliers. For example, as a low-cost airline with a fleet comprised entirely of Boeing aircraft easyjet faced substantial switching costs when it came to contemplate buying Airbus aircraft. Yet Airbus has just won a major new order from easyjet at prices reported to concede a

2 See S. Sharpe (1997), "The Effect of Consumer Switching Costs on Prices: A Theory and its Application to the Bank Deposit Market", Review of Industrial Organization 12, pp. 79-94.

3 See P. Klemperer (1995), "Competition When Consumers Have Switching Costs: An Overview with Applications to Industrial Organization, Macroeconomics, and International Trade", Review of Economic Studies 62, pp. 515-539.

60% reduction from the list price, and Airbus has also undertaken to cover the switching costs associated with training engineers to maintain the new aircraft.[4] Such instances of aggressive competition in the face of switching costs are not unusual. They show that competition in the presence of switching costs is often different, but is not necessarily any less effective, than in markets where no such costs arise.

4 See "Airbus has landed", Sunday Times, 20 October 2002.

Implications of Switching Costs for Merger Assessment

Principles of horizontal merger analysis

In any horizontal merger analysis, the fundamental object is to assess the extent to which the change in structure brought about by the merger affects the incentives of the firms involved to raise price. Horizontal merger analysis uses pre- and post-merger market share as a rough guide to the impact of a merger because, in the presence of homogeneous products, if the parties to a merger each account for a high share of the total market, then it is plausible to assume that the threat to switch from one merging firm to the other provided a significant part of the pre-merger constraint on the merging firms' pricing.

On the other hand, if the products concerned are differentiated, then any concern at loss of competition from a merger will be linked not so much to the size per se of the merging firms, but rather to the closeness of substitution between the products they sell. For example, if two thirds of the consumers who would switch away from one merging firm normally consider the other merging party's product as the closest alternative, the fears for loss of competition from the merger would be much stronger than if those who switched from the merging firms would choose predominantly products supplied by firms that continued to be rivals to the post-merger firm.

The role of switching costs

Given these basic principles of horizontal merger analysis, what are the implications when assessing a merger in the banking sector, where customers face high real or perceived switching costs?

The fact that only a relatively small proportion of bank customers change their main supplier of banking services each year is of limited relevance for the analysis of the effects of a banking merger. Consider for example the position of consumers who, due to a perception that switching costs are very high, consider themselves to be completely "locked in" or captive to their existing bank. The reduction in choice or competition between banks arising from a merger cannot have any direct effect on such consumers, since the prices they are charged by the bank are not in any way constrained by the existence of other banks. Instead, it is necessary to look at the factors that do provide a competitive constraint on the bank, and to see how those constraints are affected by the merger.[5]

5 This principle has more general application in merger analysis. It is almost always more relevant to consider the behaviour of marginal than infra-marginal consumers when assessing the impact of a merger.

Clearly, banks do compete against one another for customers (or for sections of demand) that are price sensitive and that are not "locked in" to one provider. Therefore, it is relative to these customers that it is essential to ensure that the merger will not reduce customer choice in a way that will allow the remaining banks to increase prices. For this to be the case it is required that, post-merger, customers who are willing to switch banks will continue to have sufficient credible alternatives to choose from. In order to assess the degree to which competitive pressures will be relaxed by the change of ownership structures caused by the merger, this implies a need to focus on both banks' marginal business and to assess the extent to which that business is likely to switch between the two merging banks as opposed to other providers.

The extent of any customer "lock-in" is often very difficult to assess, because the switching costs that cause inertia are dependent on the individual consumer's circumstances as well as on the nature of the product. Nevertheless, the same principle applies – competitive activity focuses on the business that is contestable, and the impact of the merger should be judged by its impact (if any) on the actual and prospective flows.

Thus, even in the presence of switching costs the same exercise as in a "conventional" industry is required, namely to identify each of the merging parties' closest competitors. But does the presence of switching costs have any influence on the identity of the main competitive constraints? As noted above, switching costs imply that firms of different sizes will have very different incentives, with the smaller firms being normally more aggressive on price than their larger rivals. This in turn implies that a merger between two firms with relatively high market shares may have less impact on competition than one in which a large bank merges with a smaller rival. Thus, normal assumptions about market shares and changes in market structure might not apply.

Switching costs in the Lloyds/Abbey case

The prediction from economic theory that small firms may provide the strongest competitive constraint in a market with switching costs was highlighted by the evidence provided by Abbey to the CC inquiry. At para 2.79 of the CC report, the situation is summarised as follows:

> "Abbey National submitted that, in markets with switching costs, firms with low market share tended to grow (or 'sow') their share by competing aggressively and through price, while those with high market share tended to exploit (or 'harvest') theirs by preserving or increasing margins on the existing customer base. The merger, it argued, would replace a firm in sowing phase with one in harvesting phase, to the detriment of consumers and competition."

The Lloyds/Abbey case also illustrates how switching costs can affect the analysis in other ways. Although smaller banks might have a stronger incentive to compete on price, the CC also believed that a bank needed to achieve a certain critical scale in order to provide a viable alternative to the major suppliers. By reducing the number of new business opportunities for an emerging supplier, the CC argued that switching costs represented a barrier to growth and made it harder for another bank to replicate the competitive presence that Abbey National had achieved. At para 2.111, the CC noted:

> "… the existence of barriers to switching makes it difficult for entrants to acquire customers at a rapid rate and exacerbates the problem of diseconomies of scale in branch networks, marketing and other costs which entrants suffer in comparison with incumbents".

Thus, not only did the merger risk eliminating a player which, due to the impact of switching costs on behaviour, would be likely to punch above its weight in competitive terms, those same switching costs would also have made it harder for other banks to grow post-merger in order to achieve the kind of challenging position that Abbey National had built up. This double impact of switching costs made the facts of this transaction particularly hard for the merging parties.[6]

Given this analysis, it is interesting to speculate on how the CC might have evaluated a merger between two of the big four UK clearing banks – a merger between Lloyds and HSBC for example.[7] In terms of market shares alone, such a merger looks much more problematic, yet the logic of the switching costs arguments ought to lead to fewer competitive concerns for such a merger. A merger between two of the major players, each of whom on the CC's own analysis is content to "harvest" its stock of existing customers rather than go out to win share from rivals, could not realistically be argued to eliminate either bank's main constraint. To the extent that customers of either bank chose to switch accounts, the likelihood is that they would change to one of the smaller challenging banks such as Abbey National, and not to one of the other majors.[8]

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This does not mean that the decision to block the merger was uncontroversial. For example, the CC relied on collective dominance concerns, arguing that the non-aggressive pricing behaviour of the leading banks indicated a pre-disposition towards co-operative behaviour. Yet the switching costs explanation for this behaviour lies in unilateral incentives, not co-ordination or collusion, so arguably one of the main planks of the CC's reasoning in the Lloyds/Abbey case was defective.

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In 1992, a hostile bid by Lloyds for Midland Bank (since re-named HSBC) was referred to the UK Monopolies and Mergers Commission. The bid was withdrawn, however, before the MMC reported.

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A scenario not dissimilar to this did emerge in the SEB/FSB merger (Case No M/2380), which involved a proposed merger between two of the four major domestic banks in Sweden. That merger was subjected to a Phase II ECMR investigation in July 2001, but was abandoned by the parties prior to completion of the inquiry.

What Lessons?

It is a well accepted idea in the economic literature that the presence of switching costs can affect the way in which competition works. This explains, and may sometimes justify, the efforts by competition and regulatory authorities to intervene to reduce switching costs in sectors such as banking and utilities.[9] When it comes to merger appraisal, there is sometimes a tendency to infer from this that the presence of switching costs automatically justifies greater intervention. But this is not the case. There are two reasons why competition authorities should resist the temptation to treat switching costs as a reason to move the goalposts.

First, the fact that a certain proportion of customers is not willing to switch either because it is locked-in or because it is not price sensitive does not have any relevance to the impact that the proposed merger has on the constraints on the merging firms. Even pre-merger there is no competition between the parties for this category of customer.

Second, the assessment of a proposed merger in a market characterised by switching costs requires an analysis of which rivals each of the merging parties would lose their (price sensitive) customers to, should they increase prices above their current level. This is no different from the type of issues that should be addressed in the assessment of a merger in a "conventional" market.

Moreover, the economic theory of switching costs can have some important and counter-intuitive implications for merger assessment. Switching costs can imply that smaller firms are generally more price aggressive than larger firms because they have more to gain and less to lose by undercutting their larger rivals. Consequently, a merger between two firms with relatively high market shares, because both parties' main competitive constraint may be represented by the smaller suppliers, can have less impact on competition than a merger that eliminated rivalry from a smaller player. The effects of switching costs need to be evaluated carefully against the circumstances of each case. They do not justify a generally more hostile approach to merger policy enforcement.

9 For example, OFGEM regularly publishes tables which show electricity and gas prices offered by domestic gas and electricity suppliers in all UK regions. This service allows customers to compare the available prices and to verify whether they are receiving the best deal. Moreover, some companies such as uswitch.com have signed up to an OFGEM voluntary code for such services and they allow customers to switch on-line.