

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS  
COMPETITION COMMITTEE**

Cancels & replaces the same document of 10 February 2014

**ROLE OF COMPETITION IN FINANCIAL CONSUMER PROTECTION**

-- Issues Paper by the Secretariat --

**26 February 2014**

*This document was prepared by the OECD Secretariat to serve as an issues paper for Session VII at the 120th meeting of the OECD Competition Committee on 26 February 2014.  
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**JT03365478**

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## COMPETITION ROLE IN FINANCIAL CONSUMER PROTECTION

*Issues Paper by the Secretariat*

### 1. Introduction

1. Competition in the financial sector and its importance to deliver “enhanced efficiency, [...] better products to final consumers, greater innovation, lower prices” (OECD, 2009) has been the subject of previous discussions of the OECD Competition Committee (see compendium in OECD, 2011). This issues paper has been prepared to support the Committee discussion of the survey circulated to members of the G20/OECD Task Force on Financial Consumer Protection (Principle 20 – Competition). It focuses on two specific aspects that complement the areas covered by the survey:

- The role of switching rates when assessing competition in retail banking services for individuals and Small and Medium Enterprises (SMEs).

Measuring competition in banking services is a complex task, due to factors such as “asymmetric information in corporate relationships, switching costs and networks in retail banking” (OECD, 2009). In particular, switching costs can reduce customers’ ability to shop around for better deals and in this way discipline the market. This paper introduces switching costs by summarising key results from the economic literature and presenting some evidence on switching costs in financial services. The paper provides a high-level discussion of switching rates and their interpretation when assessing if a market is competitive. In particular, Section 2 summarises evidence that consumers may not always choose the best alternative through switching and describes some of the factors that may explain low switching rates in banking services. It is also recognised that limited switching may not always result from lack of information or complexity of choices but may reflect consumer preferences, as suggested by insights from behavioural economics.

- Policy measures aimed at the separation of retail banking services from wholesale and investment banking.

In response to the global financial crisis, there has been renewed attention by governments and regulators to both the institutional and business structure of the financial sector and the rules that govern the behaviour of market actors. The recent policy initiatives on the reform of the banking sector consider a variety of remedies to improve the stability of the sector. These can be broadly classified into two main types of policies: (i) regulatory measures, such as setting capital requirements or liquidity standards, accompanied by enhanced supervision by the competent authorities; and (ii) measures that modify the structure of banks, such as “moving businesses identified as too risky and complex into stand-alone subsidiaries [or] prohibiting banks from engaging in these activities altogether” (Viñals et al., 2013). The debate tends to focus on the stability of the financial sector, the resilience of the overall financial system to future crises and the better protection of public finances from risks arising from the financial sector. Against this backdrop, Section 3 of this paper attempts to summarise some relevant competition issues with respect to banking separation. Specifically, it describes the implications of the “too big to fail” problem for the funding costs of larger banks and it provides a brief overview of the evidence on

economies of scale and scope in banking, as well as pointing out the risks arising from the lack of international co-ordination.

## 2. Assessment of competition – switching rates

2. This section of the issues paper briefly describes how competition is usually analysed in the financial sector, and specifically, the role switching rates play in competition analysis and assessment. The focus is on retail banking services (e.g. current accounts, loans, consumer credit) offered to individuals and Small and Medium Enterprises (SMEs).<sup>1</sup>

3. In order to assess the effectiveness of competition in retail banking services, a variety of complementary approaches can be followed (OECD, 2011a; Beck et al., 2010), including:<sup>2</sup>

- Analysing the structure of the market, by examining the evolution of market shares and concentration over time.

An increase in concentration in the market is interpreted as an indication of increased consolidation. In addition, as in the analysis of the personal current account market by the Office of Fair Trading (OFT), relatively stable levels of market shares and concentration can be seen as an indication of limited competition (OFT, 2013). The reputation of a bank is very important for consumers who may be reluctant to switch from a well-known bank to a new entrant. This consideration may contribute to explaining relatively stable bank market shares in some markets. However, as explained in OECD (2011), concentration and structural indicators are not sufficient to assess the level of competition in the financial sector. For instance, they do not take into account that “banks might not compete directly with each other in the same line of business.” Also, their interpretation is complicated by the fact that it is unclear whether market structure in the banking sector determines behaviour or vice versa (Beck et al., 2010).

- Measuring banks’ profitability.

Market studies of the banking sector can also include measures of profits<sup>3</sup> over time and in comparison with other industries, return on equity<sup>4</sup> and measures of a bank’s investment profitability<sup>5</sup> (Australian Senate, 2011). However, when the focus of the analysis is a specific relevant market rather than the entire sector, disaggregated data may not be available and therefore it may not be possible to assess profitability at the relevant market level.

- Investigating relevant service dimensions on which competition takes place, such as fees and quality of service.

The pricing of banking services consists of many dimensions, since services themselves are typically a package of several components, e.g. money order, overdraft, direct debit services. Given the fragmented nature of pricing and the number of components involved, it is not straightforward

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<sup>1</sup> This definition of retail banking is consistent with that adopted in earlier Roundtables of the OECD Competition Committee, such as OECD (2006).

<sup>2</sup> Direct measures of competition assessing the responses of prices or outputs to changes in costs are also reviewed by Beck et al. (2010) and OECD (2011a), that also notes that these measures are “increasingly used in empirical research.”

<sup>3</sup> These could be measured as profits before tax.

<sup>4</sup> Return on equity is the ratio between net income and shareholders’ equity.

<sup>5</sup> For instance, the net interest margin is an indicator of investment decisions which compares investment returns and interest expenses to assess if a firm earns more money from investment than it pays in interests.

to compare prices across different providers. In order to address the problem of comparability, the Italian Competition Authority has constructed a summary indicator that combines the different pricing components of a personal current account (AGCM, 2013).

Quality of service is not an easily observable indicator and requires suitable proxies such as consumer complaints. For instance, OFT (2013) considers how frequently the financial Ombudsman decided in favour of the customers submitting complaints and finds that, on average, this was only a minority of cases, suggesting that most market suppliers are broadly concerned about providing a good quality of service. However, the data display significant variation across different market players, potentially indicating that they do not compete very intensely on the quality of service dimension.

- Assessing barriers to entry and expansion.

Barriers to entry and expansion can be analysed in order to assess potential future changes to market structure. These barriers may arise out of regulatory obligations (Banco de Mexico, 2013), such as reserve or capital requirements, or from economic factors, such as the cost structure of the business or consumer inertia, related to search and switching costs, discussed below. For instance, retail banks typically have extensive branch networks which are increasingly complemented by internet, phone and mobile banking. Branch networks increase convenience due to proximity and positively affect brand loyalty, but they also require substantial investments and may therefore represent barriers to entry for new players.<sup>6</sup>

4. The remainder of this section is organised as follows. First, it provides an overview of switching costs in banking services. Second, it discusses the role of switching rates in assessing competition, also drawing on experience from energy markets. Third, it summarises some measures that can be implemented to encourage switching.

### 2.1. *Switching costs in banking services*

5. Switching costs arise when “transactions, learning, or pecuniary costs are incurred by a user who changes suppliers” (Klemperer, 2005). When switching costs are large, a customer is locked in after an initial purchase and this creates *ex post* market power for which firms compete *ex ante*. In other words, firms compete over a series of transactions rather than over single transactions. For this reason, individual prices may not be fully informative of the intensity of competition in the market. From a policy point of view, the question becomes whether intense *ex ante* competition is an “adequate substitute for more standard period-by-period competition without switching costs” (Klemperer, 2005). In a stylised model, it could be shown that the low initial prices paid by new customers compensate for the high prices they will be charged after lock-in, so that the total “life-cycle” payments are not affected by switching costs.

6. However, as explained by Farrell and Klemperer (2007), the literature shows that “while switching costs need not cause competitive problems, they probably do make competition more fragile.” An example of competition problem is the artificial segmentation of the market. Firms have an incentive to focus on extracting surplus from their established customer base and compete less aggressively for their rivals’ customers. Another implication is that restrictions on price discrimination may have harmful effects. When new and existing (locked-in) customers cannot be charged separate prices, large firms set higher

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<sup>6</sup> The use of the internet channel for accessing banking services varies across countries but, even when a substantial proportion of bank customers uses internet banking regularly, presumably there are customers for whom branches are important as is their convenience and proximity. Based on consumer surveys carried out in 2008 and in 2012, the OFT concluded that in the UK a branch network was important to customers and therefore it was “likely to be a barrier to entry and expansion” (OFT, 2013).

prices since they have a large base of locked-in customers to exploit, rather than setting lower prices to attract new customers (the so-called “fat-cat effect”).

7. Bundling and tying practices further complicate switching in banking services. When banks bundle services, they create so-called “shopping costs” between their products (Farrell and Klemperer, 2007), meaning that customers will incur costs if they decide to buy related products from multiple suppliers instead of the bundle.<sup>7</sup> As a result, consumers may prefer one bank that offers the entire range of services and a new entrant will consequently have to offer the full range of services in order to compete with the incumbent and to attract customers (Klemperer and Padilla, 1997). The European Commission’s inquiry found that tying practices were widespread across EU Member States, as banks required a customer to have a current account with them in order to grant mortgages or SME loans (European Commission, 2007).

8. OECD (2006) provides an overview of switching costs in banking services, including contractual costs (e.g. closing or opening charges), the administrative burden incurred by customers (e.g. arranging for standing orders and direct debits to be moved) and search costs. In particular, search costs are the monetary and non-monetary costs incurred when looking for a new supplier and they are more significant when the choice concerns complex products such as banking services. Another type of switching cost, especially in loan and credit card markets, is due to information asymmetries. The bank-customer relationship is typically based on privileged information and other banks do not necessarily know in advance the credit worthiness of a prospective client, leading to an adverse selection problem. From the point of view of high-quality customers, switching to a new bank may result in worse conditions because the provider does not have access to information on the credit worthiness of the client and therefore offers the terms that would typically offer to lower quality clients.<sup>8</sup>

9. Academic papers and policy studies provide evidence of switching costs in the financial sector. For instance, Calem et al. (2006) study US household data and find a “continuing role of informational barriers to switching between issuers for borrowers with existing large credit card balances.” Hannan and Adams (2011) find evidence of switching costs in deposits by exploiting local variation in data and flows of migration. Barone et al. (2011), using a sample of Italian firms and lending data, study firms’ decisions to switch their main<sup>9</sup> lender and conclude that “being the primary bank in the previous period increases the probability of being the main lender in the current period by 70%.” Kim et al. (2003) estimate the switching costs faced by a sample of Norwegian borrowers and find this amount to be approximately one-third of the market interest rate on loans. Additional empirical work, summarised in OECD (2006), focuses on specific elements such as the duration of bank-firm relationships or investigates the differences in firms’ switching behaviour depending on factors such as age, growth rate, market and bank characteristics.

10. Switching costs may prevent consumers from achieving better conditions, especially on banking products such as mortgages, where the amounts involved are substantial and switching costs tend to be significant and at times not very transparent.<sup>10</sup> For instance, a market study on the Australian banking

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<sup>7</sup> Shopping costs are switching costs incurred by the consumer by “choosing to buy related products from multiple suppliers rather than from a single supplier” (Farrell and Klemperer, 2007).

<sup>8</sup> This effect may be mitigated by the sharing of credit data between the banks, for instance through a credit bureau, as discussed below in the issues paper.

<sup>9</sup> Multiple banking is a widespread phenomenon among firms, including SMEs, but it is common for one of the banks to have a more important role for the firm. In this case, switching can be defined as changing the main bank.

<sup>10</sup> Resources such as owners’ associations website and more generally comparison websites alleviate the difficulties due to the complexity of the pricing structure.

sector showed that exit fees for the early repayment of mortgages were higher in Australia than in other countries and varied significantly across financial institutions in Australia, and they were considered excessive and not cost-based (Australian Senate, 2011).

11. Evidence on individuals switching at EU level,<sup>11</sup> based on 2008 Eurobarometer data, shows that a mere 9 percent of bank account holders tried to switch providers in the previous two years and 1 percent did not complete the switching process.<sup>12</sup> Equally low levels of switching were found for long-term loans, where 10 percent of customers had switched provider, while mortgages had a higher rate of 13 percent, with an additional 2 percent having tried to switch. Based on the same Eurobarometer data, the highest switching rates among the services covered by the survey<sup>13</sup> are reported for telephone (18 – 19 percent) and internet services (22 percent) and car insurance (25 percent).

12. In Australia, a survey conducted in 2010 by a consumer organisation found evidence of low switching rates for personal current account holders: only 7.6 percent of the individuals surveyed had switched bank accounts in the previous two years (CHOICE, 2010). Higher switching activity is reported on mortgages and deposits, where switches to a new lender accounted for about one third of new mortgages approved in the first half of 2011 (Australian Government, 2011).

13. More recent information from the UK confirms low levels of switching between current accounts. According to GfK's Financial Research Survey (OFT, 2013), the switching rate, measured over the previous 12 months, has gone up from 2.3 percent in 2008 to 3.1 percent in 2012 on average,<sup>14</sup> with younger consumers more inclined to switch. These data do not show yet the impact of the new switching system, launched in September 2013.

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<sup>11</sup> European Commission (2009).

<sup>12</sup> The report on the European Commission's inquiry includes switching data on both SMEs and individuals, even though they are measured differently compared with the Eurobarometer survey. Based on that information on current account holders (European Commission, 2007), average switching rates are lower for individuals than for SMEs and the longevity of the relationship with their bank is longer for individuals.

<sup>13</sup> The services included in the Eurobarometer survey were: "Current bank accounts; Savings and investment products; Mortgage loans; Long-term loan arrangements; Car insurance (for third party liability); Home insurance; Internet services (broadband); Fixed telephone services; Mobile phone services; Electricity supply services; Gas supply services (mains and bottled)."

<sup>14</sup> The Eurobarometer survey refers to switching in the previous 24 months, while in the UK survey switching is defined as "the proportion of current account holders who reported opening an account within the last 12 months by switching their main account from another bank/building society" (OFT, 2013).

### **Box 2.1. Banking services for Small and Medium Enterprises (SMEs)**

In March 2000, the Secretary of State for Trade and Industry and the Chancellor of the Exchequer asked the UK Competition Commission (“CC”) to investigate the supply of banking services by clearing banks to SMEs. After a two-year investigation<sup>15</sup>, the evidence showed a very limited degree of switching of main accounts by small and medium-sized enterprises (“SMEs”). According to the results of the investigation, many of the identified difficulties concerned the need to transfer standing order payments from the old to the new bank, remaining unpaid obligations at the customer’s old bank or the need for originators of direct debits to redirect them to the new bank.

To address the above-mentioned difficulties, the CC noted that these problems should be solvable if banks committed : (i) to improve their practices to facilitate switching, at least to a minimum industry standard to be approved by the OFT; (ii) to take steps to facilitate the switching of loans and arrangements for security; (iii) to develop portable account numbers to assist transfer of accounts between banks; (iv) to bear all the costs of switching accounts; (v) to apply a specific timetable for completion of switching, and penalties if it is not met or errors are made, plus compensation for any costs incurred by SMEs as a result; and (vi) to provide their customers with a portable credit history, to assist their ability to switch.

Concerned “about high levels of market concentration, a lack of price transparency, low levels of switching (and business inertia), and high barriers to entry and expansion for new and smaller providers”,<sup>16</sup> in June 2013 the Office of Fair Trading (“OFT”) and the Financial Conduct Authority (“FCA”) launched a new market study on banking services for SMEs. To date, the study has not yet been completed.

## **2.2. *Switching rates in the assessment of competition***

14. Switching costs and the measures aimed at their reduction are important elements in the assessment of competition in various sectors such as banking (European Commission, 2007; OFT, 2008 and 2013; Banco de Mexico, 2013), energy (see Box 2.2), and telecommunications (OECD, 2007)<sup>17</sup>.

15. Switching rates<sup>18</sup> are considered to provide an indication of the extent to which consumers are shopping around for better deals and in so doing disciplining the market. However, the economic literature shows that there are also cases in which switching may be inefficient. The survey by Farrell and Klemperer (2007) reviews a number of cases where this holds. For instance, firms charge lower prices to new customers (if they are allowed to price discriminate) and therefore a given consumer is offered different prices by different providers, even when the providers have the same cost. In this setting, inefficient switching will occur. In another example, when firms are not allowed to price discriminate, a larger firm keeps prices high to exploit its customer base. Some of this firm’s customers may face lower switching costs than others (e.g. they are more familiar with the product and have lower search costs). Therefore, the high prices induce this type of customers to switch to a smaller firm or a new entrant.

<sup>15</sup> See Competition Commission (2002), “The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK”, available at: [http://webarchive.nationalarchives.gov.uk/+http://www.competition-commission.org.uk/rep\\_pub/reports/2002/462banks.htm](http://webarchive.nationalarchives.gov.uk/+http://www.competition-commission.org.uk/rep_pub/reports/2002/462banks.htm)

<sup>16</sup> OFT (2013), Update on proposed scope for SME banking market study, September 2013.

<sup>17</sup> OECD (2007).

<sup>18</sup> There are different definitions of switching rates adopted in surveys. One way of defining the switching rate could be as the proportion of consumers that changed their main supplier over the previous 12 months.

16. Moreover, the empirical literature offers many examples where consumers switch to inferior alternatives from a menu of options. In the UK electricity market Wilson and Waddams (2010) find that, in their sample of consumers, between 17 percent and 32 percent of customers that switched providers “appear to have lost surplus through their choice.” The result is all the more striking since at the time the survey data were collected, suppliers offered effectively one tariff option therefore making comparisons relatively manageable. Similar results are also found in the telecommunications market, where findings by Economides et al. (2008) for the New York State telephone market indicate that, following new entry into the local market, around 42 percent of consumers switched to a more expensive supplier. In the financial sector, a US experiment showed that between two credit card options, over 40 percent of customers selected the more expensive one (Agarwal et al., 2006).

17. These studies suggest that, even if switching rates were “sufficiently high”, they might not be indicative of the actual discipline imposed on the market by consumer behaviour, due to the significant share of consumers making mistakes in their assessment of the best available alternative.<sup>19</sup>

### Box 2.2. Switching in the UK energy market<sup>20</sup>

Despite being liberalised in the 1990s, energy markets in the UK show a low level of consumer switching and often consumers do not switch to the best deal available. To understand why this is the case, the UK energy regulatory authority – Ofgem – launched a study in 2008.<sup>21</sup> It determined that complex tariffs together with poor comparability between suppliers aggravated existing consumer biases, such as a status quo bias. In light of these findings, Ofgem took steps aimed at simplifying energy tariffs. However, research conducted at the Centre for Competition Policy at University of East Anglia, suggests that other factors may also be relevant for understanding why the level of switching remains low.

First, consumers tend to make a decision to switch a supplier because they are expecting potential gains. A regulatory decision that reduces such gains can therefore have an impact as well on the level of switching. The developments in the UK market between 2008 and 2012 are a case in point. When Ofgem imposed a prohibition on undue price discrimination on energy suppliers, available gains were reduced by half. During that period, also the switching rate has decreased proportionally.

Second, consumers do not always choose the best deal that is available on the market, even when tariffs comparison is relatively easy. Third, consumers do not constitute a homogenous group. Consequently, to the extent that different factors affect different consumers, a set of different policies may be needed to effectively stimulate switching. Fourth, the assumption that consumers will switch to a better offer holds true only if consumers are fully rational decision makers. Unfortunately, consumers may not pay attention that is necessary in order to meaningfully engage with energy service providers. This problem is particularly acute in markets with a default supplier, as is the case in the energy sector. An experiment on the UK energy consumer market, carried out by Sitzia, Zheng and Zizzo revealed that: (i) the level of complexity of energy contracts had an impact on the number of consumers ending up with a non-optimal energy contract; and (ii) the existence of a default option affected the consumers’ choice.<sup>22</sup> Moreover, consumers may have inferential expectations, which means that they will pay attention only if potential savings are substantial.

<sup>19</sup> In addition, there may be measurement issues that distort the picture. For instance, in the energy market customers may move from having two separate providers, i.e. one for electricity and one for gas, to a dual fuel contract with one of the current providers. There is a question of whether this should count as genuine switching and therefore whether figures collected in this way could be potentially inflated.

<sup>20</sup> This box is based on Waddams, C. (2013), *Shedding light on consumer behaviour in energy markets*, in ESRC Centre for Competition Policy (2013).

<sup>21</sup> Ofgem (2008), *Energy Supply Probe – Initial Findings Report*, available at: <https://www.ofgem.gov.uk/ofgem-publications/38437/energy-supply-probe-initial-findings-report.pdf>

<sup>22</sup> Sitzia, S., Zheng, J., and D.J. Zizzo (2012), ‘Complexity and Smart Nudges with Inattentive Consumers’, *Centre for Competition Policy Working Paper*, Issue 12-13.



18. The paragraphs above provide some examples of cases when switching behaviour may not be efficient and therefore high switching rates may not necessarily indicate intense competition in the market. However, it may also be the case that low levels of switching may be compatible with effective competition. A credible threat that a sufficient share of customers would be willing to switch to a better deal can constrain prices, even when the threat does not actually materialise and customers do not switch. This is because, as mentioned in Section 2.1. above, firms compete on a life-cycle basis and take account in their pricing decisions of the possibility that, after acquiring a customer, this customer may leave for a competitor (Farrell and Klemperer, 2007). The intensity of competition to acquire new customers would therefore be a necessary complement to the assessment of switching rates for existing customers.

19. The examination of switching rates is typically associated with an analysis of the factors explaining why consumers do not search and switch (European Commission, 2009; OFT, 2008 and 2013). For instance, low levels of customer switching may be explained only in part by large switching costs. The Eurobarometer survey highlighted that only 4 percent of the sample did not try to switch current bank accounts due to difficulties in the process and 12 percent stated other reasons for not switching.<sup>23</sup> In addition, a majority of consumers (69 percent) responded that they were not interested in changing bank account.

20. A general observation is that unlike contracts for insurance services, which are renewed periodically, the banking services that display low switching rates, such as bank accounts and long-term loans, do not have a termination or renewal date. This may therefore explain, at least in part, the low level of interest by consumers in searching and switching.

21. Consumers may be satisfied with their current provider or competitive pressure may already have reduced the gains from switching. Evidence from the UK and Northern Ireland, reported in OFT (2008) and Competition Commission (2007) respectively, refers to the limited benefits of switching for some types of consumers. In particular, given the price model applied by British banks, i.e. free-if-in-credit model, there are indeed limited benefits for some types of consumers from switching. Specifically, this is the case for those customers who remain in credit and do not use unarranged overdrafts. The lack of expected gains from switching was also among the most common reasons in a consumer survey conducted in Australia (CHOICE, 2010), which found that 44 percent of consumers that had not switched current account thought that they would not find a better deal. Box 2.2 provides an example from the energy sector of a reduction in the gains from switching, resulting from the regulator's policy to ban price discrimination, and the associated fall in switching rates over the same period.

22. Another reason why consumers do not switch may be due to the fact that financial services are complex and their pricing includes several components. This may help explain consumers' difficulties in understanding the costs associated with financial services, even when the relevant information is supplied to them by their providers. As a result of limited understanding of the available services, among other factors, consumers are less engaged in searching and switching.<sup>24</sup>

23. Finally, customers that threaten to switch to an alternative provider may be able to renegotiate the applicable conditions to match alternative offers available on the market, but this effect would not be visible in the reported switching rates.

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<sup>23</sup> BEUC (2012) summarises more recent information on the barriers to switching in some European countries.

<sup>24</sup> Box 2.4. and OFT (2008) provide examples of the importance attached to information by competition authorities and policy makers. In particular, one of the key conclusions of the OFT study was that consumers did not have sufficient information to make rational choices.

### **Box 2.3. Searching and switching**

According to a survey conducted by the Centre for Competition Policy (CCP) at the University of East Anglia (UK) in 2005 in eight services markets,<sup>25</sup> the number of consumers switching from their current supplier varies across markets. However, while switching rates differ across these markets, in each market there is a 30 – 50 percent of consumers who searched but did not switch.

Zhu (2013)<sup>26</sup> identifies two types of consumers: i) consumers who search but do not switch and ii) consumers who do not search and do not switch. Satisfaction with the current provider is one of the reasons for consumers that do not search. This is also an indication that consumers are usually unaware of the existence of better deals. Consumers who search are driven by dissatisfaction with high prices charged by their current provider. Other stated reasons, such as insufficient savings or lack of time to search seem to support the argument that consumers search for better deals when they expect that searching and switching could bring potential gains.

The reasons for not searching and switching are very similar across the markets surveyed by the CCP. In addition, consumers who search and consumers who do not search report similar reasons for their behaviour. Consumers who search do not seem to find better alternatives. Interestingly, the lack of better choices is one of the concerns for the consumers who do not search in the first place. Zhu (2013) explains this lack of better alternatives with the complexity and uncertainty in searching. Consumers face uncertainty when the gain from searching and switching is merely probable and the size of probability is not clear to the new customer. Moreover, complexity appears for various reasons such as difficult comparisons, confusing switching process and need of time.

24. The paragraphs above attempt to outline some of the factors associated with low levels of switching (see also Box 2.3.). However, factors such as the lack of information and pricing complexity may explain consumer behaviour only partly, while consumer inertia may reflect consumer preferences in uncertain and complex situations. Behavioural biases may help explain consumers' decisions and support the evaluation of potential remedies. Zhu (2013) proposes two theories that could help interpret low levels of switching: (i) prospect theory, according to which agents weigh outcomes when they make decisions under uncertainty (Kahneman and Tversky, 1979); and (ii) regret theory which posits that agents make choices internalising their anticipated expectations of “regret or rejoicing once the outcome is realised” (Loomes and Sugden, 1982).

25. According to Zhu (2013), the relevant insight from prospect theory is the so-called certainty effect, according to which consumers attach greater weight to a certain outcome relative to an uncertain outcome, and the reflection effect, which means that consumers attach greater weights to losses than to gains of equal size. Based on these results, consumers are more averse to the possibility of a loss than they value a potential gain, and this reduces their propensity to switch. This effect is compounded by the uncertainty of the potential gain. Regret theory also contributes to reducing the propensity to search and switch, since it suggests that an agent may anticipate that the switching process may result in more regret because of losses than rejoicing because of equal size gains” (Zhu, 2013).

### **2.3. Remedies to reduce switching costs**

26. Possible remedies to reduce switching costs in banking services are the so-called “switching packs” or “switching arrangements”, account number portability and information sharing between financial

<sup>25</sup> The survey covered the following markets: electricity, mobile phones, fixed phones, national / overseas calls, broadband, car insurance, mortgage, current account.

<sup>26</sup> Zhu, M. (2013), “Searching and switching across markets: Is consumer ‘inertia’ the result of a mistake or a preference?”, in ESRC Centre for Competition Policy (2013), Behavioural Economics in Competition and Consumer Policy, University of East Anglia, available at <http://competitionpolicy.ac.uk/ccpbook>.

institutions. The first two measures aim at reducing the administrative burden and inconvenience of moving accounts. Information sharing between banks focuses on alleviating the problem of asymmetric information described above.

27. Switching packs involve the transfer of information between the old and the new bank so that a customer does not need to take care of the switching process, including moving all the direct debit and standing orders from one account to the other. Even though switching packs differ across countries, such systems have been adopted by a number of OECD countries such as Canada, Ireland, Italy, the Netherlands and Norway (OECD, 2009b). A recent development in this area is the launch in September 2013 by the UK Payment Council<sup>27</sup> of a current account switch service that guarantees that the switching time from an old bank account to a new bank account does not exceed seven working days. This initiative followed the review of the market by the Independent Commission on Banking<sup>28</sup> which noted the difficulties with the switching system in place and recommended a redirection service. The new system is designed to guarantee that: (i) the customer will receive whatever they need to operate the new account, like a debit card, PIN and chequebook within seven working days; (ii) the customer's new bank will arrange for all their incoming and outgoing payment instructions to be redirected from the old account to the new one; (iii) the customer's balance will be transferred to the new account; (iv) any payments sent to the old account on or after the seventh working day will be automatically "caught" and moved on to the new account; (v) the customer will not suffer if there are any bank errors; and (vi) the old current account will be closed at the end of the process.

28. Account number portability (ANP) enables customers to keep the same account number when switching and thus "almost completely removes switching costs" (OECD, 2006). However, it may require a greater degree of standardisation in payment systems and account numbers and involves substantial fixed costs.<sup>29</sup> Sweden has implemented the Bankgiro system, available only to corporate customers. All participating banks provide their customers with a universal Bankgiro number, which can be linked to any bank account and functions as a reference point to direct transactions.<sup>30</sup> At European level, the cost of an EU-wide ANP system is estimated at EUR 14.7 billion, which is deemed high relative to the objective of enhancing customer mobility and reducing the transaction costs of the switching process.<sup>31</sup>

29. The sharing of credit information among banks or other financial institutions through credit registries and credit bureaus can alleviate the switching costs arising from information asymmetries (see

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<sup>27</sup> The Payments Council is the body that sets strategy for payments in the UK. It was set up in 2007 to ensure that UK payment systems and services meet the need of payment service providers, users and the wider economy. Details on the service are available at [http://www.paymentscouncil.org.uk/files/payments\\_council/improving\\_current\\_account\\_switching\\_-\\_oct\\_2011.pdf](http://www.paymentscouncil.org.uk/files/payments_council/improving_current_account_switching_-_oct_2011.pdf)

<sup>28</sup> The Independent Commission on Banking was set up by the UK government in June 2010 to assess policies, both structural and non-structural, to reform the UK banking sector. The objective of the reforms to be proposed by the Commission was to promote financial stability and competition.

<sup>29</sup> For example in Norway, a working group examining the possible introduction of the ANP system concluded that the annual costs associated with ANP, estimated at EUR 50 million, would most probably exceed the anticipated benefits (OECD, 2009b). The Dutch banking sector considered the cost of ANP (EUR 300-500 million) to be disproportionately high when compared to the expected benefits (BEUC, 2012).

<sup>30</sup> BEUC (2012).

<sup>31</sup> See answer to a parliamentary question, 2011, available at <http://www.europarl.europa.eu/sides/getAllAnswers.do?reference=E-2011-005875&language=ET>

Section 2.1. above).<sup>32</sup> This is because potential new suppliers have access to at least some of the information on the customer held by the current bank. The beneficial effect on the customer may be two-fold: on the one hand, customers may be offered better terms, consistent with their credit worthiness, than would be the case if potential new suppliers did not have access to the information; on the other, it could be a source of discipline for borrowers and reduce the likelihood that they would become over-indebted (OECD, 2006). Credit bureaus receive information on borrowers from lenders, consolidate this information and process it to make it available back to lenders. They cover mostly consumers and firms that are smaller than those that are typically covered by rating agencies. Credit bureaus report information both on the accounts and loans held by customers, including historical records, and on customers' reliability, including the number of missed payments (IFC, 2006).

30. The positive role of such forms of credit information sharing is well-documented in the literature as summarised in OECD (2009a). However, one should note that not all forms of information sharing may be pro-competitive. For example, sharing information about the loan rates applicable to specific customers could be conducive to co-ordinated action among banks.

#### **Box 2.4. EU-level initiatives on switching arrangements**

In May 2006, the European Commission<sup>33</sup> set up the Expert Group on Customer Mobility in relation to Bank Accounts (the Group) in order to identify existing obstacles to customer mobility and to provide recommendations to the Commission on how the obstacles identified should be addressed. Its Report<sup>34</sup> presented arguments of consumer experts who claimed that information on products and prices was not transparent and hard to get, that banks imposed additional charges that were not fully transparent and price comparisons were difficult. The report presented a number of recommendations, such as (i) a pan-European study to determine in detail how the actual search and choice process for bank accounts occurs in practice in different Member States; (ii) a list of charges for retail banking products in branches and on the banks' websites; (iii) information to consumers about bank driven modifications to price lists three months before the application of new prices; (iv) a Directive which would provide a database comparing prices of products/services; and (v) an EU portal which would refer users, through links, to national comparative and information web platforms, to be created and run by the Commission.

In 2008, the European Commission invited the European Banking Industry Committee ("EBIC") to develop principles for banks' conduct in the case of consumers wishing to switch bank accounts.<sup>35</sup> These principles apply to personal current account switching within a given country. The main principle described by EBIC is that each national banking community will organise the facilitation of bank account switching in such a way that consumers can choose to address the new bank as the *Primary Contact Point* for switching their account, instead of contacting the former bank themselves. In parallel, the principles describe several obligations for both the former and the new bank in order to facilitate switching. The Common Principles for Bank Accounts Switching have been monitored for one year and in 2010 EBIC issued a report<sup>36</sup> on their implementation.

<sup>32</sup> Public credit registries are maintained by the public sector, e.g. the central bank, while a credit bureau is managed by the private sector (OECD, 2009a).

<sup>33</sup> The European Commission has recently issued a proposal for a Directive on the transparency and comparability of payment account fees, payment account switching and access to a basic payment account, see press release available at [http://europa.eu/rapid/press-release\\_IP-13-415\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-13-415_en.htm?locale=en).

<sup>34</sup> European Commission, "Report of the Expert Group on Customer Mobility in relation to Bank Accounts", 2007, available at [http://ec.europa.eu/internal\\_market/finservices-retail/baeg\\_en.htm](http://ec.europa.eu/internal_market/finservices-retail/baeg_en.htm)

<sup>35</sup> EBIC (2008), "Common Principles for Bank Accounts Switching", Available at <http://www.eubic.org/Position%20papers/2008.12.01%20Common%20Principles.pdf>

<sup>36</sup> EBIC (2010), Report on the implementation of the EBIC common principles on bank account switching, available at <http://www.eubic.org/Position%20papers/2010.08.02%20PUBLIC->

The European Consumer Organisation (“BEUC”) that has been actively involved in the account switching debate since the development of the common principles reported<sup>37</sup> that “the commitment of banks to implement their own code of conduct varies heavily among the different banking communities across Europe. While some communities have shown efforts to comply with commitments taken, for some others this self-regulation does not result in behavioural change.” Within this conclusion, BEUC recommended the following: (i) better training of bank staff; (ii) putting in place an automatic re-routing system; (iii) setting up account number portability; (iv) setting a deadline for the closure of the ‘former’ account; (v) ensuring proper enforcement and supervision and (vi) adopting binding legislation on switching.

#### Key questions for consideration:

- Has competition in the banking sector been assessed in your jurisdiction? If so, what were the factors and indicators that influenced most the final conclusions?
- Has this analysis concluded that competition is more intense on new customers? If so, how has this affected the overall conclusions on the sector or market?
- Have any surveys of the searching and switching behaviour of individuals and SMEs been conducted in recent years? Are there any differences in switching behaviour across the different banking services? What are the main barriers to searching and switching in your jurisdiction?

### 3. Banking separation

31. In response to the global financial crisis, there has been renewed attention by governments and regulators to both the institutional and business structure of the financial sector and the rules that govern the behaviour of market actors. For instance in the US the Dodd–Frank Wall Street Reform and Consumer Protection Act, voted in 2010, is a wide-ranging reform of the regulatory system.<sup>38</sup> In Europe, the UK government established in 2010 the Independent Commission on Banking to assess policies to reform the UK banking sector. The recommendations of the Independent Commission (“Vickers” report) included measures on separation (Vickers, 2011) that have been passed into the Financial Services (Banking Reform) Act 2013.<sup>39</sup> The European Commission, among other policy initiatives, set up in 2012 a group of experts to work on structural bank reform and their recommendations were presented in the so-called Liikanen report (Liikanen, 2012). Recently, the European Commission has also issued its draft proposals for structural reform.<sup>40,41</sup>

[%20EBIC%20Implementation%20Report%20-%20Common%20Principles%20on%20Bank%20Account%20Switching%20July2010H.pdf](#)

<sup>37</sup> BEUC (2011), “Easy Switching? – A long way to go”, BEUC Monitoring Report of the Common Principles for Bank Account Switching, January 2011, available at <http://www.beuc.org/custom/2011-00183-01-E.pdf>

<sup>38</sup> Available at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm>.

<sup>39</sup> Available at <http://www.legislation.gov.uk/ukpga/2013/33/contents/enacted>.

<sup>40</sup> European Commission (2014), Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, COM(2014) 43 final, 29 January 2014, available at [http://ec.europa.eu/internal\\_market/bank/docs/structural-reform/140129\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/structural-reform/140129_proposal_en.pdf).

32. A variety of sources (Liikanen, 2012; Viñals et al., 2013; Blundell-Wignall et al., 2013) have voiced concerns that the structure of the banking sector – where many institutions are considered to be systemically important due to their size, their essential role within the financial system and the degree of interconnectedness with other financial institutions and markets<sup>42</sup> – has contributed to the spreading of the financial crisis and its knock-on effects throughout the rest of the economy. In particular, the systemically important banks might enjoy a benefit from the implicit guarantee that they will be supported by public funds; such a guarantee would distort the incentives of managers in risk taking (Vickers, 2011; Blundell-Wignall et al., 2013). The failure of a bank to appropriately manage risk imposes an externality on all the banking system since it leads to the risk of contagion. Moreover, this effect is exacerbated by the combination within the same entity of retail banking services with wholesale and investment banking, including trading, which have different risk and profitability profiles. In light of this, various forms of separation (or more precisely ring-fencing) of retail banking, on the one hand, and investment banking, on the other, have been proposed. As outlined in the Liikanen report, “the central objectives of the separation are to make banking groups, especially their socially most vital parts (mainly deposit-taking and providing financial services to the non-financial sectors in the economy), safer and less connected to high-risk trading activities and to limit the implicit or explicit stake of taxpayer in the trading parts of banking groups” (Liikanen, 2012).

33. In particular, the advantages identified by the proponents of banking separation (e.g. Vickers, 2011) include the following:

- Separation would insulate retail banking from financial shocks, including shocks due to the banks’ exposure to international markets.
- Separation would enable regulators and policy makers to design better-targeted policies for banks and, if the need arose, to ‘resolve’ banks that were in financial difficulties. As a result, a more orderly resolution process would reduce both the risk of contagion and the need for taxpayer money. It would also ensure that the provision of retail banking services, for which customers have no immediate alternatives, would not be interrupted in the event of difficulties.
- If accompanied by measures that required transparency by the banks, separation would help promote a better supervision of the market by the competent authorities.

34. The disadvantages of separation, in the various forms proposed, range from the potential loss of economies of scale and diversification to the implementation costs involved (Viñals et al., 2013).

35. Most of the studies on separation in the banking sector assess the merit of this measure through the lens of its expected impact on the stability of the financial system. However, financial regulation and especially a measure that would alter the structure of the market, such as bank separation, may also influence competitive outcomes. The OECD Competition Committee and its Working Parties have addressed the question of the interplay between prudential regulation and competition on previous occasions (see the compendium in OECD (2011)).

36. The present discussion focuses on separation measures. Firstly, this section briefly describes the basic features of the structural measures proposed in some OECD countries. Secondly, it draws a parallel with separation policies in other sectors. Thirdly, it summarises the main implications of banking separation from a competition perspective.

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<sup>41</sup> The follow-up to the Liikanen report, including the public consultation and the recent proposed Regulation, are available at [http://ec.europa.eu/internal\\_market/bank/structural-reform/index\\_en.htm](http://ec.europa.eu/internal_market/bank/structural-reform/index_en.htm).

<sup>42</sup> FSB, IMF and BIS (2009).



### 3.1. *Models of banking separation*

37. A few OECD countries have either adopted or are considering structural policies. These include the Volcker rule in the US,<sup>43</sup> the Liikanen report to the European Commission,<sup>44</sup> the proposals of the Independent Commission on Banking in the UK<sup>45</sup> and legislation in France and Germany.<sup>46</sup>

38. The main features of banking separation proposals concern: (i) the activities that are to be separated; (ii) the strength of separation; and (iii) de minimis exemptions. The line of separation in the proposals lies somewhere between “commercial” and “investment” banking businesses. As summarised by the European Commission (2013), examples of retail commercial banking activities include insured deposit taking, lending to households and SMEs, and the provision of payment system services, while examples of wholesale and investment banking include underwriting, market making and proprietary trading. The strength of separation,<sup>47</sup> i.e. how “thick” the line is between the separated activities, could range from functional separation (that requires a firm to set up a separate unit within the same legal body) to a stricter rule imposing full ownership separation (which requires a firm to set a legally separate entity), such as the approach of the 1933 Glass-Steagall Act in the US. A brief overview of the Act’s provisions and their impact on the market is provided in Box 3.2. As for the banks potentially subject to separation, structural remedies may apply only to the largest retail banks or to all deposit-taking banking institutions. For instance, an appropriate threshold may be defined in terms of the importance of derivatives, wholesale funding and trading assets on the total assets of the bank (Blundell-Wignall et al., 2013).

39. The current separation measures vary somewhat along the three characteristics described above. In particular:

- The US Volcker rule, as implemented in the Dodd-Frank legislation, restricts the ability of banks to undertake proprietary trading,<sup>48</sup> with exemptions including hedging, market making and trading in US government securities (Gambacorta and van Rixtel, 2013). Since the prohibition applies not only to deposit-funded commercial banks in the US but also to any affiliate, the

<sup>43</sup> The Volcker rule is implemented in the US through the section 619 in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed by President Obama in July 2010. See footnote 38.

<sup>44</sup> The European Commission released on 29 January 2014 a proposed Regulation on separation, see footnote 40.

<sup>45</sup> The Financial Services (Banking Reform) Act 2013 implements the proposals of the Vickers report concerning ring-fencing. See footnote 39.

<sup>46</sup> France and Germany are the first two European Union member states to adopt a legislative regulation for the separation of banking in the aftermath of the financial crisis. The French Law ‘Loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires’ is available at: <http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000027754539>. The German law ‘Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen’ is available at: <http://dipbt.bundestag.de/dip21/brd/2013/0094-13.pdf>. Both laws require that separation of banking activities must take place by July 2015.

<sup>47</sup> A milder form of separation, accounting separation, is imposed for example on dominant telecommunications operators in a number of jurisdictions to help address price discrimination issues between the vertically integrated firm and its downstream competitors.

<sup>48</sup> Proprietary trading refers to the bank trading on its own account for the purpose of making profits (see [http://europa.eu/rapid/press-release\\_IP-14-85\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-14-85_en.htm?locale=en)).

Volcker rule effectively imposes ownership restrictions. Moreover, it applies to all deposit-taking institutions, regardless of their size.<sup>49</sup>

- The proposals in the Liikanen report to the European Commission involve moving proprietary trading and other significant trading activities to a separate legal entity, which however is allowed to remain within the same group as a deposit-taking institution. Based on the proposal, if trading activities amount to a significant share of a bank's business or are above a minimum threshold, the bank would be subject to an evaluation by the bank's supervisory authority, such as the relevant national body or the central bank. Under the proposed Regulation recently issued by the European Commission, supervisory authorities would have the power to require banks to move to a separate entity activities such as market-making and the trading of derivatives. The draft Regulation, in line with the Volcker rule, will prevent proprietary trading in financial instruments and commodities. Finally, the proposal applies only to the largest institutions in Europe.
- The reforms implemented in the UK<sup>50</sup> include ring-fencing retail deposits of individuals and SMEs from “a range of activities that are not directly connected to providing payment services and making loans”. As explained in the Vickers report, the services that are not permitted include “trading book activities, derivatives trading and services relating to secondary markets activity” (Vickers, 2011). In practice, the ring-fenced activities could be placed within a wider banking group but the relationships between the different parts of the group would be conducted on an arm's length basis.

40. In the remainder of this section, we refer to considerations which are generally applicable to the various definitions of separation. However, the differences among the proposals may imply different consequences for the market, and interact differently with other policy measures, such as capital requirements. As an example, Blundell-Wignall et al. (2013) show for illustrative purposes the implication of the authors' proposal on a typical universal bank. The proposal advocates the ring-fencing of the securities businesses from the core deposit bank, combined with a separate leverage ratio on the core deposit bank, whereas the securities businesses would be subject to the global capital requirements. Blundell-Wignall et al. (2013) show that their proposal results in a safer structure<sup>51</sup> and a substantial improvement compared with the *status quo*.

41. The box below compares in a simplified manner these three models of structural separation for financial services.

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<sup>49</sup> While the Volcker rule bears some resemblance to the Glass-Steagall Act 1933, it is less restrictive as it bans fewer main dealing activities than the Glass-Steagall Act did. Moreover, it allows full securities underwriting if offered by a subsidiary within the bank holding company.

<sup>50</sup> The Financial Services (Banking Reform) Act 2013, among other provisions, implements the recommendations of the Vickers report concerning separation. See footnote 39.

<sup>51</sup> The paper relies on the distance-to-default (DTD), “a measure that uses a combination of bank reported data and market information to calculate the number of standard deviations a bank is from the default point” (Blundell-Wignall et al. 2013).



**Box 3.1. Summary of separation options<sup>52</sup>**

	<b>Liikanen group report</b>	<b>United Kingdom</b>	<b>United States</b>
<b>Holding company with banking and trading activities</b>	Permitted	Permitted	Not permitted
<b>Deposit taking institution engaged in proprietary trading in securities and derivatives</b>	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Not permitted <sup>53</sup>
<b>Deposit taking institution investing in hedge funds and private equity</b>	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Not permitted
<b>Deposit taking institution providing market making services</b>	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Not permitted
<b>Higher loss absorbency rule</b>	Yes, via leverage ratio for trading business that exceeds size threshold	Yes, as add-on to the conservation buffer for UK ring-fenced bank	For SIBs with substantial US footprint <sup>54</sup>
<b>Size threshold for application</b>	Yes; applies to all banks with trading books larger than €100 billion, or trading assets more than 15-25% of balance-sheet	Yes; applies to all banks and building societies with deposits greater than £25 billion	No
<b>Enacted into law</b>	No	Scheduled for completion in 2015	Dodd-Frank Act
<b>Implementing regulations finalized?</b>	No	No	No

Source: Viñals et al. (2013)

### 3.2. *Selected international experience with banking separation*

42. As mentioned above, the separation between retail services, on the one hand, and wholesale and investment banking activities, on the other, was in force in the U.S. following the approval of the Glass-Steagall Act in 1933 (see Box 3.2.). Other countries implemented similar policies during the Great Depression, such as Belgium and Italy, and in the 1940s (such as France and Japan). There were also a few countries (Canada, UK) where the separation was not imposed by legal obligations but existed due to market practice.

<sup>52</sup> The UK Financial Services (Banking Reform) Act 2013 received Royal Assent on 18 December 2013, after the publication of Viñals et al. (2013).

<sup>53</sup> US federal government and agency securities, debt and securities issued by US state and municipal governments and government sponsored enterprises, and derivatives on these securities are exempt from proprietary trading restrictions of the Volcker rule.

<sup>54</sup> The Dodd-Frank Act subjects US banks with assets in excess of \$50 billion to more stringent prudential requirements.

43. In the aftermath of the Great Depression, the proximity between banks and industry was the subject of intense debate in a number of countries.<sup>55</sup> In Belgium and in Italy, banks were forced to concentrate on deposit taking and to divest their shares in industrial and commercial activities. In 1934, Belgium passed a decree requiring universal banks to separate their deposit-taking activities from their investment banking activities.<sup>56</sup> In Italy, a 1936 law split universal banks into commercial banks and investment banks.<sup>57</sup> Both countries lifted these restrictions in the early 1990s.

44. In France, the separation between commercial banks and investment banks, allowed to be involved in long-term credit and investment, was imposed in 1945<sup>58</sup> and was removed in 1984 by the Banking Act. A version of the Glass-Steagall Act was also adopted in Japan.<sup>59</sup> The separation of banking and securities firms in Japan is based on Article 65 of the Financial Instruments and Exchange Act of 1948<sup>60</sup> which prohibits banks, among others, from underwriting securities.

45. Canada also used to have a separation between commercial and investment activities. However, prior to 1980, this restriction existed by custom and tradition rather than on the basis of an expressed prohibition. This changed in 1980 with the adoption of the Bank Act, which prohibited chartered banks from underwriting corporate securities and offering investment counselling. In 1987, amendments to the Act revoked the part of the law concerning separation, thereby opening the securities market to Canadian chartered as well as foreign banks.<sup>61</sup> Equally, the UK had separate commercial banks and merchant banks that were specialised in providing access to capital markets, as required for example by large institutions for infrastructure projects.<sup>62</sup> The separation was fully lifted with the liberalisation of the financial sector in 1986.

46. One of the most restrictive forms of separation observed in the financial market has been implemented in China<sup>63</sup> in 1993 in accordance with the Resolution on Financial System Reform and Article 43 of the Law on Commercial Banks of 1995. The latter prohibits commercial banks from making trust investment, trading in shares, making investment in fixed assets of non-self use or making investment in non-banking institutions and enterprises within the People's Republic of China.<sup>64</sup> As the Chinese

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<sup>55</sup> European Commission (2014).

<sup>56</sup> Available at <http://www.nbb.be/doc/ts/publications/economicreview/1934/1934.08.25-BULL.pdf>.

<sup>57</sup> See [http://www.bancaditalia.it/bancaditalia/storia/1936/la\\_depressione](http://www.bancaditalia.it/bancaditalia/storia/1936/la_depressione).

<sup>58</sup> See [http://www.fbf.fr/en/french-banking-sector/history-of-banks-in-france/5---between-the-state-and-the-market-\(since-1945\)](http://www.fbf.fr/en/french-banking-sector/history-of-banks-in-france/5---between-the-state-and-the-market-(since-1945)).

<sup>59</sup> Dale (1987). Prior to 1948, Japan had followed the European model and developed a system of universal rather than separated banking.

<sup>60</sup> The original 1948 law was called the Securities and Exchange Law, but it was later amended into the Financial Instruments and Exchange Act, available at <http://www.fsa.go.jp/news/19/ginkou/20080627-4/02.pdf>.

<sup>61</sup> Freedman (1992).

<sup>62</sup> Goodhart (2013).

<sup>63</sup> Institute of International Bankers (2011).

<sup>64</sup> In accordance with Article 6 of the Securities Law of the People's Republic of China of 1998: "Securities business shall be engaged in and administered as a business separate from the banking business, trust business and insurance business. Securities companies shall be established separately from banks, trust companies and insurance companies". Likewise, Article 104 of the Insurance Law of the People's Republic of China Of 1995 states: "The use of fund of the insurance company is restricted only to bank deposit,

Academy of Social Science explains, the decision to implement a strict form of separation in the banking sector was made upon the conclusion of comparative studies on the American model of separated banking and the European model of universal banking.<sup>65</sup> However, in order to promote and fully participate in the development of capital markets, China has decided to gradually loosen existing restrictions in the banking sector. The first step in this direction was taken in 2004 when the relevant provisions were amended by inserting a clause allowing for “the exception stipulated by the State”.<sup>66</sup>

### Box 3.2. Lessons from the Glass-Steagall Act

In response to the failure of nearly 5,000 banks during the Great Depression,<sup>67</sup> the United States Congress passed in 1933 the Glass-Steagall Act which halted the shift toward “universal” banking by prohibiting commercial banks from dealing in securities and investment banks from taking deposits. The separation between commercial banks and investment banks was primarily driven by a concern that involvement of commercial banks in underwriting corporate securities would create significant conflict of interest, which could be exploited by banks. This in turn could threaten the stability of the financial system.

Four prohibitions were instrumental to implementing separation. Most importantly, sections 16 and 20 banned national and state-chartered banks that were members of the Federal Reserve System from underwriting corporate debt and equity securities. Section 21, on the other hand, prohibited entities involved in underwriting securities from accepting deposits. Despite these restrictions, the Glass-Steagall Act contained a number of loopholes that allowed both regulators and banks to effectively bypass many provisions of the Act, in particular by reinterpreting Section 20 of the Act.<sup>68</sup> These reinterpretations have, for example, led the Federal Reserve to allow banks, on a case-by-case basis, to set up special Section 20 subsidiaries that could engage in certain securities activities.

While economists who have examined the effects of the Act argued that it has “unwisely protected investment banks from competition and has been unnecessary to prevent banks from undertaking excessive risk”,<sup>69</sup> most studies on the impact of the Act focused on the conflict of interest and risk issues. Gande *et al.* suggest that the paucity of studies on the competitive structure of the corporate debt underwriting can be explained by the fact that the Glass-Steagall Act effectively protected the investment banking industry.<sup>70</sup> However, with the gradual erosion of prohibitions laid down in the Act, commercial banks have become actively involved in the securities underwriting market, and examination of the impact of separation on competition has become feasible.

For example, Kim *et al.* (2008) examine whether the entry of commercial banks into the market for underwriting has produced a pro-competitive effect on underwriting spreads over a 30-year period.<sup>71</sup> In their study,

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trading of government bonds and financial bonds and other forms of fund utilisation stipulated by the State Council. The fund of the insurance company may not be used to set up securities operation organisations or to invest in enterprises”.

<sup>65</sup> Chinese Academy of Social Sciences (2001).

<sup>66</sup> Such amendments were made with respect to Article 43 of Law on Commercial Banks and Article 6 of the Securities Law. For a more detailed overview of the Chinese banking model see Loechel and Xiang Li (2010).

<sup>67</sup> New York Times, ‘Glass-Steagall Act (1933)’, available at: [http://topics.nytimes.com/top/reference/timestopics/subjects/g/glass\\_steagall\\_act\\_1933/](http://topics.nytimes.com/top/reference/timestopics/subjects/g/glass_steagall_act_1933/)

<sup>68</sup> Gande, A., Puri, M., and A. Saunders (1999), “Bank entry, competition, and the market for corporate securities underwriting”, *Journal of Financial Economics*, vol. 54, pp. 165-195.

<sup>69</sup> Litan, R.E. (1988), “Reuniting investment and commercial banking”, *Cato Journal*, pp. 803-821.

<sup>70</sup> Gande et al. (1999).

<sup>71</sup> Gande *et al.* explain that two major factors determine underwriter spreads: various types of costs (i.e. distribution costs, information production costs, *etc.*) and the degree of competition in the market, and in particular whether underwriters can extract monopoly rents.

the authors define three different regimes which reflect the stages of the legislation that dissolved the separation between commercial banks and investment banks in underwriting.<sup>72</sup> During the least competitive Regime 1, which lasted from 1975 until 1989 with respect to initial public offerings (IPOs) and seasoned equity offerings (SEOs) (and until 1988 with respect to debt issues), commercial banks were banned from underwriting any issues. Regime 2 – concerning years 1990-1998 for IPOs and SEOs, and 1989-1998 for debt - was characterised by a limited degree of competition as commercial banks got involved in underwriting issues through subsidiaries established on the basis of Section 20. Finally, during the most competitive Regime 3, covering the period 1999-2004 for IPOs, SEOs and debt issue, commercial banks could fully compete with investment banks in the market for underwriting issues as previously imposed restriction have effectively been removed.

The authors find that first, entering commercial banks have generally charged lower underwriting spreads. Second, their analysis revealed “the least competitive underwriting market (Regime 1) to have the highest underwriting spreads, followed by the restricted and full competitive underwriting markets”. Overall, the authors conclude that their findings support the view that the entry of commercial banks into the market for underwriting has had a procompetitive effect in the form of reduced underwriting spreads.<sup>73</sup>

### 3.3. Separation in other sectors

47. In 2001, the OECD Council issued a Recommendation Concerning Structural Separation in Regulated Industries,<sup>74</sup> which advocates the consideration of the benefits and costs of structural separation of potentially competitive activities from non-competitive activities of regulated firms. The regulated firm provides the non-competitive service (e.g. access to a network) to rival downstream or upstream firms and the terms at which this input is provided to competitors might restrict competition. A structural remedy may prove necessary when behavioural policies, such as access regulation, are insufficient to achieve a level-playing field between the regulated firm and its competitors. The recommendation recognises that the balancing of costs and benefits must reflect the different characteristics of individual industries and countries, and that the degree of competition which can be sustained in the competitive complementary activities varies.

48. In 2006 and 2011, the Competition Committee reported to the Council on the implementation of the Recommendation.<sup>75</sup> Structural separation has been implemented by various countries in sectors such as electricity, gas, railways and telecommunications. For example, requirements on the separation of network activities involving a natural monopoly are in force in the EU for the electricity and gas sectors. The OECD Reports conclude that it is unusual for a vertically integrated company to initiate the process of separation, even though voluntary commitments can be useful to pre-empt the intervention of a regulator imposing structural remedies.

49. While the OECD Reports clearly show that structural separation as a remedy is capable of delivering a number of benefits, it is important to recognise that the implementation of this remedy in network industries and in the banking sector has different underlying concerns. In particular, structural

<sup>72</sup> Kim, D., Palia, D., and A. Saunders (2008), “The impact of commercial banks on underwriting spreads: Evidence from three decades”, *Journal of Financial and Quantitative Analysis*, vol. 43, no. 4, pp. 975-1000.

<sup>73</sup> Ibid. Also Gande *et al.* have reached a similar conclusion. Moreover, they found that the early evidence of bank entry points to the decreasing market concentration. (Gande *et al.*, whose study has been published in 1999, noted that banks have been acquiring investment banks only since 1997).

<sup>74</sup> OECD (2001). The recommendation was amended in 2011.

<sup>75</sup> OECD (2006a).

OECD (2011b).

separation in network industries, characterised by the presence of natural monopoly, seeks to restructure the previously publicly-owned monopolies and to introduce more competition by isolating those elements that cannot be replicated. In the financial sector, on the other hand, the central objective of separation is ring-fencing, i.e. the protection of the vital parts of the banking groups from higher-risk activities.

### 3.4. *Implications of banking separation for competition*

50. It is difficult to anticipate the potential effects of separation policies on competition in the banking sector. Separation would alter the structure of the industry and the incentives of market players in complex ways; ultimately, effects will depend on the specific form of separation imposed on the market and on how it is implemented.<sup>76</sup> In the remainder of this section, we sketch some high-level considerations on how competition may be affected. The discussion assumes that the line around the protected parts of the business is “thick” enough, especially at times of financial difficulty, i.e. that separation is credible.<sup>77</sup>

#### 3.4.1. *Funding costs*

51. Systemic banks enjoy a benefit from the implicit guarantee that they will be supported by public funds. The implicit guarantee reduces the risk of a systemic bank from investors’ and creditors’ point of view. In consequence, these lenders are willing to accept a lower return on the capital they allocate to a large bank, which therefore enjoys lower funding costs on debt and equity than would be the case in the absence of this implicit subsidy.<sup>78</sup> In summary, a large bank benefits from a lower cost base than its competitors, for reasons that are unrelated to its efficiency. Consequently, separation would reduce bank size and in part address competitive distortions between banks that are “too big to fail” and smaller banks.

52. As noted in the Vickers report (Vickers, 2011), there is evidence that large systemic banks benefit from the anticipated government intervention, for instance in terms of a lower cost of equity and higher market capitalisation.<sup>79</sup> Recent papers confirm that systemically large banks experience lower interest costs and offer shareholders a lower return on equity (Bertay et al., 2013; Gandhi and Lustig, 2010), even though there may be other contributing factors, such as diversification of risk obtained from a larger portfolio of loans and deposits (Hughes and Mester, 2013). These findings are complemented by evidence from the financial crisis, indicating that larger banking institutions were indeed more likely to obtain government support and therefore the expectations of shareholders and creditors were fulfilled in recent years. As reported in an IMF working paper, during the recent crisis banks that were large relative to their “home country economy and/or which accounted for a large share of national deposits [were] more likely to receive official support in the event of distress than other types of banks” (Ötcker-Robe et al.,

<sup>76</sup> Separation would not necessarily be restricted solely to separating retail from other forms of banking but could also include splitting up existing retail banks, as suggested in a recent UK proposal by the Labour party. BBC Labour to Froce Bank Breakups, 16 January 2014. (<http://www.bbc.co.uk/news/business-25768906>)

<sup>77</sup> The potential lack of credibility could arise because, if one subsidiary in a banking group were close to failure, it might be optimal to save it through internal transfers from the rest of the group. Similarly to the time inconsistency problem widely studied in the economic literature, if investors and creditors anticipated the incentive to subsidise the bank *ex post*, they would assess risk as if the bank was a single entity, i.e. regardless of whether separation had been imposed or not.

<sup>78</sup> Noss and Sowerbutts (2012) review the implicit subsidy of UK banks. Schich and Lindh (2012) review the main approaches to measuring implicit guarantees and provide estimates of the reduction in funding costs due to implicit guarantee in selected European countries.

<sup>79</sup> Credit rating agencies typically take account of the implicit government support for “too big to fail” banks. *Ceteris paribus*, these banks would be assigned higher ratings with potential further impact on funding costs.

2011). In particular, the likelihood of official support for distressed banks in the top quartile by assets size was over 90%, while banks in the lowest quartile had less than 20% likelihood of receiving official support.<sup>80</sup>

53. Related to the point above, “banks seen by consumers as too big to fail can give rise to competitive distortions since they may have an artificial advantage” in attracting deposits (OECD, 2011). Since consumers perceive these banks as safer than the others they are inclined to allocate a greater share of funds than would otherwise be the case. In turn, this advantage may reduce competitive pressure on larger banks leading to relatively higher fees and lower quality of service. While deposit insurance mitigates this effect, it is a guarantee that is often applicable only to deposits below a given amount and therefore protects only a part of a customer’s wealth from a bank’s failure. Finally, since the deposit base is typically the cheapest source of funding for banks, depositors effectively cross-subsidise more risky and remunerative activities for the bank.

#### 3.4.1.1. Risk and return

54. Banks that enjoy lower funding costs can raise more equity and debt, and use the additional funds to expand their business, including by investing in assets or funding projects that are risky.<sup>81</sup> The argument on excessive risk-taking is emphasised in the financial literature and the policy documents on separation (Vickers, 2011). It also has implications from a competition point of view, since banks that pursue riskier strategies also benefit from higher returns on average. Therefore they have the ability to potentially obtain higher returns than their competitors. By removing the implicit subsidy that lowers the cost of capital of large banks, separation would also contribute to removing this competitive distortion.

#### 3.4.2. *Economies of scale and scope*

55. When assessing the benefits and costs of separation, an important element to consider is the cost structure of the sector, namely if banks are characterised by economies of scale and scope. Economies of scale reflect the reduction in unit costs that banks can achieve in activities which require substantial fixed costs, such as the provision and processing of payment transactions. Economies of scope in the context of banking services can arise from cost economies of scope, the cross-selling of products and the risk diversification available to banks that combine different services, where these services provide income streams that are not perfectly correlated (Liikanen, 2012).

56. The evidence on economies of scale and scope in banking is mixed. As summarised by Gambacorta and van Rixtel (2013), industry studies find substantial benefits from size and diversification. This finding would imply loss of scale and synergies from mandating bank separation. However, academic studies do not confirm widely these results and paint a more varied picture, emphasising the conceptual and technical complexity of the estimation (Boot, 2011; DeYoung, 2010; Wheelock and Wilson, 2012). In particular, some studies (Amel et al. 2004) find evidence of economies of scale but only until the bank approaches a large size and there does not appear to be a consensus on the asset level at which economies of scale are exhausted (Liikanen, 2012). The mixed results in the literature are reflected in the policy debate, where some view economies of scale as significant while others consider that this is not the most important factor in banking policy (Mester, 2010; DeYoung, 2010). Evidence on economies of scope suggests that there are many downsides to diversification. While there is evidence on economies of scope

<sup>80</sup> Ötoker-Robe et al. (2011) define the likelihood of support given distress as “the share of institutions that received official support as a percent of the total number of institutions that were in distress in each quartile.”

<sup>81</sup> For instance, a project that is assessed on the basis of its Net Present Value (NPV) is more likely to be financed if the discount rate (i.e. the cost of capital) is lower.

in combining deposit-taking and lending, two traditional banking services, it is not clear that the same holds for other activities. Indeed, the review in Gambacorta and van Rixtel (2013) highlights that there is considerable evidence that product diversification has negative effects, especially when commercial banks diversify into investment banking activities. Organisational complexity is also an important factor and can contribute to the explanation of the diversification discount.

57. Another consideration related to economies of scope and diversification is about conflict of interest. For instance, conflicts of interest arise “if banks underwrite equity and bank customers use the proceeds to repay bank loans. Conflicts can also arise if banks make loans to customers who purchase other bank underwritten securities or additionally if banks use proprietary customer lending information to direct underwriting” (Cyree, 2000). Imposing bank separation would remove conflicts of interest or at least alleviate them.

58. As a general point, separation may enhance the bank’s reputation and contribute to increasing transparency towards customers. It would also reduce the scope for larger banks to exploit any advantages from sharing clients and clients’ information across their different activities, and would therefore result in a more level-playing field for small and large banks alike. However, the extent to which conflicts of interest are mitigated by separation depends on the specific measures implemented in a given country. In the example from Cyree (2000), the conflict of interest would presumably be addressed under the legislation inspired by the Vickers proposals in the UK, because the underwriting business would be restricted and would not be performed by the ring-fenced bank.

### 3.4.3. *International co-ordination*

59. The policy initiatives on separation that are under discussion or have been implemented in OECD countries differ in respect of the breadth of activities they cover and how strict the separation is between the activities. If different countries adopt different rules, distortions in the international allocation of capital will arise benefitting the banking institutions that operate where rules are more favourable. These banks would potentially be able to raise capital at lower cost than banks in other countries and they would enjoy a competitive advantage on international markets (e.g. trading, M&A, asset management). If this was the case, the lack of international co-ordination may potentially provide an incentive to banking institutions to operate in certain countries, where the regulatory regime is more favourable. In addition, the separation requirements imposed at national level will interact with global regulations, such as those on capital and liquidity. The overall effect of these two sets of policy measures will depend on the specific business model of the banks, as affected by separation requirements (Blundell-Wignall et al, 2013). Finally, the lack of international co-ordination would lead to higher compliance costs (Viñals et al., 2013).<sup>82</sup>

#### **Key questions for consideration:**

- Have there been proposals on banking separation in your jurisdiction? What is their status?
- What benefits would banking separation deliver in terms of competition? If this question has been analysed in your jurisdiction, please provide details of the type of analysis that has been carried out.
- Has there been any customer survey on the choice of retail bank by customers? If so, what are the main drivers of customers’ choice? Are customers aware of, and do they value, the implicit guarantee enjoyed by large and systemically important institutions?

<sup>82</sup> According to reports, Morgan Stanley estimates that divergence among new rules would cost the world’s biggest banks \$15 billion a year in total (Reuters, 2014).

#### **4. Concluding remarks**

60. The high-level principles developed by the G20/OECD Task Force are designed to enhance “consumer protection in the field of financial services” (G20/OECD Task Force, 2011). These principles explicitly recognise the importance of competitive markets in delivering greater choice to consumers and in providing incentives to market players to improve their offerings. Switching costs in banking services, compounded with other factors such as the complexity of the product and its pricing, prevent consumers from fully enjoying the benefits of competition. While there may be limited gains from switching under specific circumstances, for many consumers there would be sufficient potential gains to be made from changing supplier (Australian government, 2011). The transparency and comparability of fees are necessary conditions to enable consumers to compare alternative products. In addition, policy measures to lower the barriers to switching have been adopted in a number of jurisdictions. From a consumer protection perspective, additional considerations include ensuring that an easier switching process still complies with appropriate data protection requirements and introducing safeguards to verify that a customer has indeed requested switching provider.

61. Targeted measures to enhance consumer protection complement the existing regulatory framework for the supervision of banks and other financial institutions (G20, 2011). Financial regulation can foster consumers’ confidence in retail financial products and market players, and more widely in the financial system. Against this backdrop, the debate on banking separation has implications for financial consumer protection ranging from addressing conflicts of interest to improving financial stability and resilience against future crises.



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