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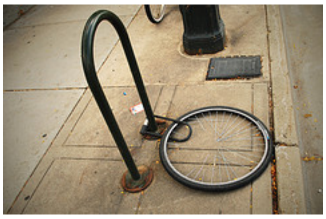
Online banking, switching costs and competition: a complex story

Posted by **Paul Belleflamme** on 18/1/2012 • Categorized as **Internet**, **Software**

In **an article published last October in the New York Times**, Nelson D. Schwartz suggests that online banking creates switching costs and, thereby, reduces competition in the US banking sector. The title of the article summarizes the argument in a forceful way: "*Online Banking Keeps Customers on Hook for Fees*". Mr. Schwartz illustrates his point with the following anecdote:

> *"Tedd Speck, a 49-year-old market researcher in Kent, Conn., was furious about Bank of America's planned $5 monthly fee for debit card use. But he is staying put after being overwhelmed by the inconvenience of moving dozens of online bill paying arrangements to another bank."*

You probably use online banking yourself to pay your bills, to transfer money across your accounts or simply to access your account information, whenever and wherever it pleases you. You will then agree with me that these services are conveniences that you are willing to pay for. For the sake of the argument, say that you value these services up to 100 euros per year.



However, whether or not you have already tried to do so, you can easily imagine the hassle of switching your accounts from one bank to another. On top of learning to use another interface, you might have to create a new list of payees, of direct debits, etc. Again, for the sake of the argument, say that you estimate at 50 euros the value of the time and energy that you would spend when switching online banking services.

Such switching costs clearly put your bank in a strong position. Instead of charging you its online banking services at 100 euros per year (i.e., the value that you attach to the services), your bank can increase the fee up to 150 euros (i.e., the value + the switching costs) without fearing that you would leave. In economic terms, switching costs decrease the price-elasticity of demand; it becomes harder to substitute one service for another, which reduces the consumers' sensitivity to price increases. Consumers are indeed "*kept on hook*".

Yet, does the latter — undisputed — fact necessarily mean that online banking services (and the switching costs they create) reduce competition and make customers worse off? The New York Time article follows this line of argument:

> *"With 44 million households having used the Internet to pay a bill in the past 30 days — up from 32 million five years ago and projected to reach 55 million by 2016 — it's a shift that has major ramifications for competition. There's even evidence that fewer consumers are switching banks, with 7 percent of them estimated to be moving their primary account to a different institution in 2011, down from 12 percent last year, according to surveys by Javelin Strategy and Research."*

Mr. Schwartz sees thus a causal relationship between the increase in the adoption of online banking services, the reduction in the level of consumer switching and lower competition in the US banking sector.

Personally, I would be much more cautious before drawing any conclusion from the previous facts. First of all, as well known in economics, correlation is not causality! Second, I would like you to think about some causal effects that Mr. Schwartz may have ignored or underestimated. In particular, I propose as food for thoughts the following two quotes taken from a **report published by the Office of Fair Trading** (the competition authority in the UK) in 2003:

> *"As firms realise that they can price above cost to customers once they are locked-in, then these customers become extremely valuable. As a result, competition can mean that firms price very low, even below cost to attract new customers."*
>
> *"If switching costs are very low then prices may adjust to prevent customers from switching. So a low level of switching need not imply that switching costs are high."*

You may also want to look at the current **advertising campaign of Deutsche Bank in Belgium**, which is precisely focused on switching costs. The ad starts with these words: "*What would happen if your supermarket behaved like your bank does?*" It then shows a cashier asking customers to pay, on top of their bill, additional charges for renting the shopping trolley, for using the conveyor belt, for not having a loyalty card, etc. The ad ends with this question and this 'suggestion': "*You don't accept unnecessary charges in your supermarket; why do you in your bank? Switch now to deutschebank.be*."

Tagged as: banking sector, online banking, switching costs

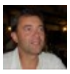
Paul Belleflamme is professor at Université catholique de Louvain. He is attached to the Center for Operations Research and Econometrics (CORE) and to the Louvain School of Management, where he teaches courses in the fields of Industrial Organization and Managerial Economics. **More info & contact**

43 Comments

1. **webdesign belgie** 1 Comment
   17/07/2012 • 10:26

   Hello to every one, as I am truly eager of reading this webpage's post to be updated on a regular basis. It contains good information.

   Reply

   - 
     Alain Strowel 144 Comments
     17/07/2012 • 11:05

     We will try to offer updates on a more regular basis. Thanks

     Reply

2. *Maxime Lefèvre* 4 Comments
   22/02/2012 • 15:34

   I think the basic argument of the article is not warranted. Why would the online banking create transfer fees? These transfer fees exist for both online and offline banking. Besides, I think the online banking facilitates transfers (account creation online, quick and easy movement of money).

   Then I think the online banking increases competition because consumers have access to new banks, foreign and often with little or no physical presence in the country. This seems clearly increase competition and therefore contradicts the argument of Mr. Schwartz.

   Then it is obvious to note that correlation does not equal causation. Such detours are often illogical and easily performed, it is important to pay attention to "established assertions" with no logical reasoning behind and not to believe everything that is said to be obvious.

   Reply

3. *Bahibigwi* 7 Comments
   22/02/2012 • 14:40

   When customers perceive switching costs to be high (associated with leaving the current relationship and establishing a new one), they tend to be loyal. switching costs as one factor that determines the competitiveness of market environment, since high switching costs discourage consumers to switch to alternate providers but The impact of switching cost will be different when the consumer is advanced online banking users and when he's a basic online banking users. In fact once a customer moves to full-service online banking with electronic bill payments and automatic fund transfers, the likelihood of that customer moving to another bank is significantly diminished.
   The construct of switching costs could be conceptualized as the perception of the magnitude of additional costs required for online banking users to terminate the current relationship with their main online bank and secure an alternative. Switching costs are identified as a factor contributing to maintaining a relationship (Morgan and Hunt, 1994 **http://www.dwaynewhitten.com/delme2/dsj.pdf**). Morgan and Hunt stated that switching costs are of an economic nature only. However, switching cost may comprise psychological and emotional costs also.

   Reply

4. *Jean-François Marenne* 1 Comment

22/02/2012 • 13:41

Generally banking services for individuals are already a market with long term contract , loyal and quite uninformed customers and high switching costs which does not encourage competition. And I agree with Nelson D. Schwartz's to say that new online services developed by banks further increase these costs. This can further reduce competition and encourage collusive and unfair practices among banks that offer these services. Of course I agree also with most to say that customers agree to be locked in and to have switching costs only in exchange of better benefits and services. But the problem is that the online services are now became a standard of the banks, it's something that they have to if they want to remain comptetitive. So, ultimately (although I took some shortcuts) customers are more locked in by banks to take advantage of standard services. However, even if the switching costs have greatly increased, I don't think banks can fully take advantage of the situation. I think indeed that a very important part of the customers really don't like to be locked in, especially under unfair conditions. And they will pay the switching costs enven if they are high if they feel they aren't treated fairly and they will. This part of the customers is also generally the more informed and it's more on this part of the demand that the banks will compete. It's like a negociable part of the demand (the others are the "lazy" customers defined by Amandine Seny) and this part is more demanding. So a competition has to remain if the banks want to attract this part. The importance of switching costs only change the size of the negociable and the non-negociable parts of the demand.

Reply

5. *Maxime Delahaut* 2 Comments
22/02/2012 • 11:18

As others pointed it out, there is to be a trade-off between ex-ante competition, the competition that faces a firm when it wants to acquire a new client, and ex-post competition, the competition between firms when clients are locked-in.

On the one hand, the banks invest a lot to attract new clients. The advertising campaign of Deutsche Bank is one example. If you want to lure away potential clients from your competitors, you need to convince these clients that they will be happier with your services. As a result, ex-ante competition between firms is increased.

On the other hand, when the clients are locked-in, banks 'incentives to start competing fiercely is greatly reduced as one needs to invest more in order to "unlocked" clients As a matter of fact, it was made clear in previous posts that many forces lock clients. For instance, the so called "matter of habit" is a major obstacle faced by competitors when trying to steal clients. Indeed, which price is to be put on "matter of habit" when you know clients have heterogeneous preferences.

My point is that a lower ex-post level of competition does not imply that competition in the banking sector creates market inefficiencies. Indeed, ex-ante competition might act as a leverage effect that contributes to restore banks' incentives to play the game and so create a desirable level of competition.

However, I have to add an element that Mr Schwartz did not take into account and which affects the level of ex-ante competition. Network effects strengthen the lock-in dynamic. As a bank reaches a critical mass among clusters, it locks the cluster in. For instance, a family will often have the same bank for more convenience. A typical case could be that first the father is lured away by the bank, then the mother follows (for more convenience) and finally the children are naturally locked in. So, in this case, the bank needed only to attract the father (and reach some kind of critical mass) to capture the rest of the family (i.e. the cluster). This case can be enlarged to clusters of friends, colleagues and so on.

As a result of network effects, the bank will not need to invest so much to attract all the clients. Targeted commercials would do the job to reach the critical mass and start the snow ball. This could, according to me, reduce greatly ex-ante competition.

NB: I found the following article helpful: Coordination and lock in: competition with switching costs and network effects from Paul Klemperer (2006)

Reply

- 
  Paul Belleflamme 262 Comments
  22/02/2012 • 11:49

  You are absolutely right to point that network effects can create a form of "collective switching costs". The article of Paul Klemperer is an excellent survey, which I could have put on the reading list.

  Reply

6. *Géraldine Mottard* 5 Comments
22/02/2012 • 08:20

"Nelson D. Schwartz suggests that online banking creates switching costs and, thereby, reduces competition in the US banking sector." Nevertheless, I think there are other elements to take into account to analyse the competition. For example, the online banking sector is at a national level. So there are maybe more banks in competition comparatively to the offline-banking sector that is at a local level in the US. Moreover, in the online banking sector, there are banks which are online and offline, and banks which are only online. Consequently, there is a higher number of banks and this can lead to more competition.

Concerning the fact that there are less people switching of banks, I think there are also other elements than switching costs to take into account. Perhaps that some people don't switch because they don't even look at other banks and this for several reasons.
Some people can choose and stay in a big bank because they associate a big bank with security. And even if they can get higher rates or other advantages in another bank, they maybe don't have enough money to matter. (**http://baselinescenario.com/2009/10/26/bank-switching-costs/**)
Moreover, some people are in a bank and, as they are satisfied, they don't even look if there is another bank with better or additional services.
In an other hand, some people switch banks even if there are switching costs because there is a better service in another bank or because their bank doesn't seem anymore safe to them (especially in these times of crisis). Moreover, the switching costs are sometimes minimal when you move to a bank like the Deutsche Bank.

Reply

-  ***Paul Belleflamme*** 262 Comments
  22/02/2012 • 08:27

  You raise two important points when it comes to assess the effect of switching costs on market competition. The first is the definition of the market (which market are we talking about?). The second is product differentiation: consumers may not want to switch simply because they value more the services of their current supplier.

  Reply

7. *Alexandre Jund* 5 Comments
22/02/2012 • 00:45

The first question that comes by reading this article is : what is really the issue here ? what is the problem ?

And although the NYTimes article is not really complete (why didn't they compare with numbers of switching before online banking, like 10 years ago) their conclusion is all right : "Online Banking Keeps Customers on Hook for Fees", "but it's very convenient".

In one word, yes banks have people pay fees and try to hook them up to gain more revenues. However it's not a something very new. Yet online banking is less, i think, creating a hold up than the situation without online banking where you had to go to the bank, or make a phone call, etc …
I don't think consumers are worse off because the cost of switching has decreased with the internet, so rolling the logic of this article the fees the banks could claim are lower.

Secondly, the data is not maybe a good indicator because the last years following the crisis have been very difficult for banks and finance and source of uncertainty, consumers were more reluctant to switch even if they had to pay a little extra.

Reply

8. *Cindy Hoyez* 5 Comments
21/02/2012 • 17:53

When a customer wants to change bank, it requires time and effort. Moreover, he/she is going to lose information. Those faced switching costs are called transportation costs. According to Nelson D. Schwartz, "online banking creates switching costs and, thereby, reduces competition in the US banking sector". From an intuitive point of view, it is true that banks increase their source of market power thanks to those switching costs. Once customers are locked-in because of switching costs, banks expect higher prices. However, as the report of the Office of Fair Trading quoted it, since banks are aware that consumers are more valuable for them in front of switching costs, they will compete fiercely for new consumers. So, at the first glance, it is not clear that switching costs relax competition in the US banking sector.

Another element that we have to take into account is the consumer behaviour. Indeed, the customers keep not always their preferences from one period to the next. It happens that they change their preferences because of unforeseen obligations. As most of consumers keep their preferences from one period to the next in the banking sector (currently 7% of consumers are switching banks against 12% last year), switching costs will indeed relax price competition. But, in the case of unrelated preferences, the conclusion is the opposite: switching costs deepen price competition. Depending on the consumer behaviour, the switching costs lead to a more or less competitive market so that it is really important to take into account consumer behaviour.

Reply

-  ***Paul Belleflamme*** 262 Comments
  21/02/2012 • 18:15

  This is a good summary of our menu for next lecture.

  Reply

9. *Olivier Lê* 5 Comments
21/02/2012 • 16:01

Indeed, at least in Belgium, switching cost in the financial industry is high but it tends to decrease. In 2008, only 7% of Belgian had open a new account in another bank. To make it easier, the bank in Belgium need to fulfill the majority of the step to transfer client account by themselves (1 November 2009).
http://www.lalibre.be/economie/libre-entreprise/article/538061/changer-de-banque-devient-plus-facile.html

It's good to notice that more Belgian has decided to transfer their bank account to another institution. In fact, this decision is linked to a better informed consumer thanks to association such as "Test-Achats".
http://www.dhnet.be/infos/economie/article/372553/environ-49400-belges-ont-change-de-banque-ces-dix-derniers-mois.html

Companies like Deutsche Bank or Keytrade have a totally new way of working. Instead of asking for money to cover all different kind of expenses, they are doing it for free… or they are even giving money! Definitely, those companies know that customer have a switching cost and they are trying to interest as many people with free fees to lower this cost. In any case, those two companies is increasing the competition in the bank sector.

In other words, I would say that a high switching cost will interest many firms because the consumer is much more valuable (see quote above in the text). Financial sector stand in this category (Customer Relationship Management (CRM) is important). The other way around, a lower switching cost makes firms interest to have as many consumer as possible to make profit. In any case, competition between firms is present.

Reply

-  ***Paul Belleflamme*** 262 Comments
  21/02/2012 • 18:16

  Thanks for these precisions about the Belgian market.

  Reply

10. *Antoine Sencie* 4 Comments
21/02/2012 • 14:17

My thoughts regarding the assertion written in the article are mitigated. On one hand switching costs are an incentive for customers to stay in their banks, but on the other hand it is also an incentive for the other firms to try to decrease the value consumers give to those switching costs.

Hence, it is why I think that claiming that competition is reduced by the occurrence of switching costs is too wide. I think the competition between banks to attract new customers will always remain the same (here when talking about new customers, I mean people who don't use yet an online banking system); the only difference is that banks will compete on a higher price which will be their price + the switching cost. So it is the same competition as every bank has to raise its price by the same amount, this price can be seen as a new norm. Here the assumption is made that the banks know the switching costs of the consumers and so they can increase their price. But in reality I don't think that such increase is reflected as switching is not a cost for the banks. So competition will maybe take place in the range of service offer when a customer comes from one bank to another…

What I can understand is the decrease of competition for consumers who are already involved with a bank, in other words, the existing clients of the bank. Indeed the more a consumer has to pay to switch to another bank; the lowest will be the incentive to do so. So a reasonable answer for the bank to keep attracting consumers seems to be the decrease of their price, but also try to show to consumer that the switching costs to their bank is not that high (here it is the duty of the marketing service, but the idea is always the same: offer the lowest price).

The fact that competition is reduced by the occurrence of such switching costs depends on the consumer strategy set by the banks. Some banks will try to give the possibility for the consumer to come more easily to their bank by setting, for example, more general banking software that are can more easily compatible with the data from the other banks. There will be banks that will use these switching costs to retain their clients, by setting online services which are not easily transferable, but other will try to reduce the switching costs in the mind of the clients by offering help during a switching from one bank to another; like I have said upper. A bank that can reduce by 10 the switching cost of a consumer should get the entire market share (it is a theoretical assumption that requires that conditions as transparency or complete information are met).

I will conclude with this question: As switching costs for online banking services become more and more common, shouldn't it be consider more as the new norm of price?

Reply

-  ***Paul Belleflamme*** 262 Comments
  21/02/2012 • 15:02

  You are right to point that banks can resort to different strategies. During the lecture, we will contrast 'pay to stay' and 'pay to switch' strategies.

  Reply

11. *ouadoudy amina* 2 Comments
21/02/2012 • 07:47

I think a bank can get simultanesouly 2 kind of profits. that means it can sell its products/services by setting different prices for different customers. For people or customers who exist already, the bank act as a monopolist and set higher prices. In reality the bank do little for these existing customers once they are locked in (they are given less advandages compared to new customers). And for new customers, I think there has been always fierce competition and banks do lower their prices in order to attract more and more customers in order to increase their market share. So switching cost, in my own view, make it possible for the bank to make some higher profits in some segments.

Reply

-  ***Paul Belleflamme*** 262 Comments
  21/02/2012 • 08:27

  I agree with your view but you seem to assume that consumers are myopic, in the sense that they do not anticipate, when they are "new" consumers, that they will be locked-in and exploited later on. In other words, when analyzing such markets, we shouldn't forget that "existing" customers were once "new" customers.

  Reply

  - *ouadoudy amina* 2 Comments
    21/02/2012 • 10:44

    they think probably it will be the same thing when they change their supplier to go elsewhere!!! that what told me many people i have discussed with about why they couldn't change when their bank charged additional fees..

    Reply

12. *ZHAO Hanqing* 5 Comments
20/02/2012 • 12:23

Heres my two cents

It's only nature to see better banks have more customers, and with more customers, these banks became larger, and vice versa, so it's kinda like a positive spiral. In the end, only few big banks won and become oligopoly.

The small banks want to survive this movement, one thing they could do would be to put up a high switching cost, to prevent losing more customers. In other words, this cost functions like a cocoon, a shield, against the harsh competition bestowed upon these small banks.

On the other hand, the cost can be seen as a promise, even for big banks. In the sense that, when you buy lunch from Mcdonald, you know that they are not that good, but they are cheap, fast and serves the need for student, and now think the exactly opposite, you are in a high price restaurant, you know you will have high-quality food and service by the moment you enter their door. Why so? well, in someway, the price is the justification, because they charge high, they should worth it.

If such is the logic, then the high switching cost does, and should imply a better customer service, for the banks. Hence, promise.

One last thought, for the banks ads that encourage people to use their cards and such , by offering them free, which, is always good strategy to attract customer. Combines it with the high switching cost. This "easy in, hard out" works in harmony…if not in irony.

Reply

13. *Amandine Seny* 5 Comments
20/02/2012 • 11:35

On the one hand, switching costs make banks provide many benefits in the beginning to the consumers, in order to attract them as much as possible, which is good for competition. On the other hand, it's true that, once the consumers are "affiliated", locked in to the bank, competition is reduced, which leads to higher prices. The point is to see the compensating effect between the fact that there is a lot of competition at the beginning in order to attract consumers, and the fact that there is less competition in the next period due to the consumer's affiliation and switching costs.

I now want to quote another point that I have read in an article talking about competition in banking: "in the case of banking, price competition tends to encourage overly speculative behaviours, which essentially entail acceptance of excessive risk, with a resultant volatility that could potentially harm depositors, and ultimately compromise the stability of the economic system as a whole." (Donatella Porrini and Giovanni Battista Ramello, "Competition in Banking: Switching Costs and the Limits of Antitrust Enforcement », **http://papers.ssrn.com/sol3/papers.cfm?abstract_id=530483**). The fact that there are switching costs in the banking sector seems thus to help economic stability, which is better for the consumers. What they loose with their higher prices due to switching costs, they might gain it in end.

Moreover, online banking is a service that is convenient for consumers. Everything can be done from home and consumers see their travel costs decrease. Who would be glad to have such a service removed, even if it would be better for competition? Switching costs appear, but the travel costs decrease, which might also be considered as a compensating effect. If competition is reduced, it's due to the consumers' choice to use the online services.

Mr. Miller says that if you decide another bank is better, you should be able to change. But my point here is that people ARE able to change (as seen in the DB advertising, one signature would be enough), they just don't want to take their time to do it and to learn how to use a new platform (a previous comment pointed out the "manner of habit", the "psychological switching cost"). If people are too "lazy" to do so and value the fact of being a consumer of one specific bank, and if banks know that their consumers don't want to go through the inconveniences of switching to another bank, I don't see why banks shouldn't have the right to make the consumers pay for it. We shouldn't forget that a bank is a business whose objective is to maximize its profit… Maybe banks should be managed publically, but that's another debate…

Reply

-  ***Paul Belleflamme*** 262 Comments
  20/02/2012 • 11:44

  Very good points, and thanks for the reference.

  Reply

14. *Janowski Joachim* 5 Comments
20/02/2012 • 09:36

By reading this article, we could believe that online banking is the worst thing that happened for bank's customers and competition. However, it turns out that the easiness of operating form and the trust relation that it bonds with your bank is more important than ever in our society. We live in a selfish society; bank managers know that the proximity with their customers is important and create special bonds. Indeed, more you wait before changing bank, more your bank owns intern information, which permits it to create higher switching costs for customer. Which makes that the customer stay in his bank and increase long term relation. This little reasoning proves the setting up of a vicious circle.

For me, the main influence which affects switching costs is long term relation that customer creates with his bank. Several costs can be come from long term relation such as the loss of good reputation, trust relation with administrative system or closing and opening bank account. Personally, I think it's difficult to know how much it could cost for customers to leave their bank for another bank, but apparently, as it said in the article, the switching cost is estimated to 50 euros.

Another thing about the article that strikes me is the price of value. Indeed, value that we attribute to a bank can play a role if we want to change bank but I find hard to estimate the price of a personal value. Take the example of Microsoft and Apple, it would be hard for a Microsoft User to buy an Apple tool because they don't have the same value at all. By contrast, if we take Ford and GM example, it is easier for a customer of ford to buy a GM car because of the same value that they represent for customers. We can say if it would be hard or not, but for my part, pricing these values is subjective. How is it possible?

I saw the results of an experiment of Kim-Glider-Vale (2000) [Source : **http://fic.wharton.upenn.edu/fic/papers/01/0113.pdf** that i found particularly interesting about the switching costs. They present a model to explain the behavior of certain firms and try to assess the switching cost, which explain partly my precedent question.

Additionally, the experiment shows that 23 percent of added value of a consumer is bringing by lock-in phenomenon. According to results, 35 percent of average market share is due to relation that customer establish with his bank. In analyzing these results, we can say that switching costs are not insignificant and confirm the idea that bank domain is a sector where switching costs evolve with long term relation.

Reply

-  ***Paul Belleflamme*** 262 Comments
  20/02/2012 • 09:41

  Thanks for the reference!

  Reply

15. *Watteau Jonathan* 7 Comments
20/02/2012 • 09:07

There are also behavioral reasons witch reduce the competition. Most of us are reluctant to change, as explained in some theories of human resource management. So I think we tend to be loyal to the companies to keep our routine.

However, this loyalty is low rewarded. Indeed, most of the actions of banks, in terms of reduction of costs, are to attract new clients and not to keep them.

So, with the damaged image of banks because of the crisis and the new fees introduced by the austerity plan that banks will certainly reverbarate on their clients, I think we will see a greater trend to switch. We will be able to enjoy more the attractive campaign of banks. Moreover, those campaigns may be more competitive in response to the need of banks to raise the amount of their deposits to satisfy the recommendations of Basle III. Those campaigns could involve the transfer of the data's (list of payees, of direct debits,..) and switching bank would be like switching energy supplier, it would only require an internet registration without any costs.

Reply

- *Watteau Jonathan* 7 Comments
  20/02/2012 • 12:10

  As previously said, fidelity is generally low rewarded. But the trend is to attract new client and retain them by a fidelity prime. Some example of the new campaigns:

  http://www.agents.axa.be/agent/site/grandjean/epargne-placements/comptes_d_epargne/epargneplus.aspx

  https://www.bpo.be/portal/Start.asp

  https://www.deltalloydbank.be/fr_be/products/star/superior.aspx

  https://www.dexia.be/info/fr/iws/home.html#page=%2Finfo%2FFR%2FEpargnerEtInvestir%2FProduitsParCategorie%2FComptesDepargn

  In Basle III, the net stable funding ratio (NSFR) compares available funding sources with funding needs resulting from the assets on the balance sheet.
  The funding sources have to be greater than the funding needs, and the weighting of the private deposits is 80%-90% which is a funding source. This is a reason for the bank to attract more depositors. According to this, the switching costs should be decreased by banks to have new clients.

  Reply

  - ***Paul Belleflamme*** 262 Comments
    20/02/2012 • 13:22

    Interesting perspective, thanks.

    Reply

16. *Séverine Duym* 5 Comments
19/02/2012 • 22:08

This article made me think about the case of the mobile phone industry. Indeed, few years ago, switching from an operator to another was very costly for the customers. They had to change their phone number, to inform all their contacts, etc.
But, nowadays, if a customer wants to change from one operator to another, it is more easy because technologies have evolved. A customer can keep his phone number when changing of operator.
With this example, I try to demonstrate that the banks should be careful about the evolution of the technologies because it can affect the effects of the switching costs! If a technology allows customers to change from one bank to another more easily, it will increase the competition between banks. This comment is only valid if all the information is visible.

To make a link with the comments of the article, I will now react to the following sentence :
"As firms realise that they can price above cost to customers once they are locked-in, then these customers become extremely valuable. As a result, competition can mean that firms price very low, even below cost to attract new customers."
According to me, this sentence is valid up to a point. Indeed, if customers know the "real" prices of the services once they are linked to the firm, they will probably compare those prices with different firms and will choose the less costly. So, their decision/willingness to pay will depend on their long or short term vision (= they want to stay a long time in the organization or not) and of the access to information !
The banks have an incentive to hide their « long term prices » if they are high (lack of prices' visibility) and to make lots of ad about the low prices of opening an account to attract new customers, as it is notified in the citation.
Here, the government can play a role, by constraining the banks to give a list of service prices available to improve the capacity of comparison of the customers.

Reply

- ***Paul Belleflamme*** 262 Comments
  20/02/2012 • 07:34

  You are right to point that "technologies can affect the effects of switching costs". Intermediaries may also emerge to exploit such technologies and capture some of the value that consumers attach to switching (or to staying with their current suppliers, depending on the way you see it).

  Reply

17. *Gauthier Vandeleene* 5 Comments

19/02/2012 • 19:43

If I'm not mistaken, I'd say this is clearly a problem of tranparency of prices. Following Test-Achat, a well-know belgian agency for the protection of consumers,

"Transparence ?
Or il est difficile pour le consommateur de comparer toutes les formules tarifaires disponibles sur le marché. En effet, les forfaits et leurs coûts cachés se multiplient. Et de manière générale, les banques rivalisent d'ingéniosité pour rendre illisible leur feuille tarifaire."
(In english: Tranparency?
It is indeed hard for consumers to compare all the tariffs available on the market. Actually, the packages (fixed prices) and their hidden costs are multiplied. In general, banks compete in terms of ingenuity to make their tariff's brochure impossible to read.)

http://www.test-achats.be/paiements/cout-des-comptes-a-vue-test-achats-met-en-ligne-un-nouveau-simulateur-avec-le-soutien-des-autorites-publiques-s639853.htm

So, as Diamond showed, because consumers don't know all the tariff's charged by the banks and their levels, banks can charge the maximum price, for example, costs for switching your accounts to another bank.

Moreover, in the more accurate theory of Spatial price dispersion (Salop & Stiglitz), some consumers know well that they can go to some banks which won't charge them a lot, like pure online banks such as Keytrade, and some other consumers, the great majority of the population, can stay in their traditionnal bank, because they don't feel the fees to be to high, compare to the services the banks give.

We could also think about the fact that more or less absolutely everyone needs a bank nowadays. The demand is so high, and the offer or number of establishments so small, they can easily collude in industry associations like Febelfin in Belgium to agree on setting the biggest fees. They enjoy a great market power.

What should be done by authorities is completely explained in this article by the same agency Test-Achat, in french sorry, a good exercice for my erasmus collegues.

http://www.test-achats.be/pratiques-du-commerce/messieurs-les-banquiers-vos-tarifs-s-v-p-s533043.htm

Reply

- 
  Paul Belleflamme 262 Comments
  19/02/2012 • 20:39

  You're totally right to point that search costs are a source of switching costs.

  Reply

18. *Mathieu Zen* 7 Comments
18/02/2012 • 16:27

Authorities are taking laws to make easier bank switching. However, there are some points to mention when we talk about competition among banks. Comparisons between banks are not easy to do because there are lots of differentiating factors.

- Interest rates, fidelity bonus, entry bonus, temporary interest rates (6 first months)
- Operation fees: monthly, quarterly, cards … (fees are sometimes function of the operations number)

Because banks make use of those artifacts, there's a lack of prices visibility. Some management fees do that we end up with a negative interest for bank accounts with little money on it.

However, some studies have been done to advise people wanting to switch (article CRIOC: **http://www.oivo-crioc.org/files/fr/5904fr.pdf** in French) and some websites are proposing comparison between banks (e.g. **http://www.guide-epargne.be/**).

There's also another thing to mention. With the financial crisis, some clients are more cautious with their money and are now aware of some risks. They decide maybe now more than before not "to keep their eggs in the same basket". Maybe that's why now banks do more advertising to reassure clients about their services and to attract those who are not convinced by their current financial organism.

Finally, I'll add a concept of cultural vision. In some societies, people are more "switch averse". Banks should know these cultural concepts when they try to address a market.

Reply

- 
  Paul Belleflamme 262 Comments
  19/02/2012 • 20:43

You raise a number of interesting points. Thanks.

Reply

19. *Maria Ryjoukhina* 4 Comments
18/02/2012 • 12:45

Although I agree that online banking increases the total cost that would imply the switch from one bank to another, I don't think that the increase of the switching cost would be very significant.

The consumers often chose one bank, and then stay loyal to it. The costs related to banking are usually not significant enough to be a reason for changing. So, being loyal to one bank is probably more a matter of habit than of cost considerations.

I think that for the majority of clients, if they decided to switch from one bank to another, it would rather be driven by fear of seeing the bank going bankrupt (for example during the crisis of Fortis), or because some other bank offers other incentives to change (for example, more attractive interest rates on investments or on mortgage loans).

Therefore, I think that banks already have the possibility to increase their fees without losing customers, even without the online services. Furthermore, the use of online banking could probably increase the switching costs, but the effect wouldn't be that important, because the customers were already hooked before the introduction of these online services.

Reply

-  ***Paul Belleflamme*** 262 Comments
  19/02/2012 • 20:41

  This "matter of habit" that you are rightfully referring to is a form of "psychological" switching cost.

  Reply

20. *Falisse Estelle* 5 Comments
18/02/2012 • 11:09

I'll here keep going over the issue that Alain Strowel raised over standards and interoperability compared to switching cost in the banking sector.
As we have seen in the class of economics of innovation, patent allows firms to get a protection for a while and then the innovation falls in the public domain it increases the incentive to innovate and then the diffusion is complete. We can compare this situation to the switching costs in the banking sector. When switching costs are high or at least present, banks are sure or almost sure that clients are not willing to switch to another bank.They have a protection which incentivize them to increase their technology and improve their systems. In opposite, when no switching cost, banks may loose many consumers in one time due to some external factors. Because of the risks, banks are not wiling to increase their system.
The presence of switching costs in the banking system can here be seen as an insurance.

Reply

-  ***Paul Belleflamme*** 262 Comments
  19/02/2012 • 20:47

  If I follow you correctly, switching costs decrease competition and, thereby, increase incentives to innovate. This is an intriguing claim, which should be analyzed further.

  Reply

21. *Olivier Simons* 5 Comments
15/02/2012 • 18:32

The title of Nelson D. Schwartz's article seems to consider online banking services only as a negative thing for consumers: "Online Banking Keeps Customers on Hook for Fees". His argument lies on the economic effects of switching costs on consumers' choice and (hence) on competition in the banking industries (both reduced). Such switching costs clearly put banks in a strong position with respect to their customers. I think we have to put into perspective this "one-way" argument.

First, it is more fair, and quite obvious, to recognize the positive effects of online banking on consumer welfare. Simply because they value this service (because "it's convenient and safe" (A. pace) and because it makes easier a lot of money transactions which also hugely simplify the management of all kinds of firms) they are willing to pay for it. However, and that's the point of N. Schwartz, these services are nowadays designed in a way that they create significant switching costs, which as a result lock-in consumers to the bank they have been until now.

There are thus at least two aspects to consider and it's why Emmett Higdon talks about online bill payment product as a "double-edged sword" for consumers. He explains this as follows: "while customers value the convenience, inside the industry it was known that it would be a powerful retention tool. That's why online bill paying went free in the first place." This last sentence shows clearly the benefit for consumers to enjoy, in the beginning, a free service that they value quite a lot. The true issue should be thus more about to know whether the benefits of consumers offset the costs they pay by being locked-in to one bank, or not. Theoretically, we may thus find win-win situations where customers pay for a valuable service and where banks earn reasonable profits by providing this service.

In this debate, Banks (obviously) argue that the fee is only there to "allows us (the banks) to continue offering the benefits that customers have come to expect from our debit card […]" says A. Pace, but it's likely that, though, banks exploit these switching costs to charge price that in fine cost more to customers than the benefits they enjoy (because they face as costs not only the fees but also the switching costs). M. Schwanhausser says indeed that "There's a certain amount of pain you can inflict on customers without losing them and the banks are all doing careful calculations about what customers are willing to pay for." They know indeed how to hold their customers by consciously making them harder to switch. In these cases, banks clearly make the "cost-benefits trade-off" faced by customers incline towards higher costs for them and higher profits for banks.

Moreover, we may wonder if banks are not fixing together the amount of the fees, in other words, if they are colluding, which is also turned to be detrimental to consumers. The democrat Miller asked the US Justice Department to have a look on this issue.

Aside of the fact that consumers value these services, we can find other arguments that put into perspective the Schwartz's quote.

In a report made by the Office Fair Trade, the authors say that "firms can find it advantageous to create switching costs where previously none existed. In this way, they can make customers more loyal and less price-sensitive and thus earn higher profits". This strategy is called the "bargain-then-rip-off" strategy. The goal is straightforward for banks: the larger is their customer base, the higher the profit they can earn by charging high prices on these locked-in customers. Therefore, this customer base becomes valuable for banks that want to grow it. The competition is then fiercer between banks which ends up with very low prices to attract the contestable part of demand and/or the uncommitted consumers. Hence, with such prices, the consumer welfare is unambiguously enhanced (at this time). It's worth mentioning that the market features influence the strength with which the effects at play will influence the competition (mature or growing market, price discrimination feasible or not, etc.); for instance it's obvious that competition is fiercer on growing markets because a lot of consumers are still not buying from a particular firm.

A personal interpretation I want to make here is the following: I think we can see these switching costs as a "complementor" (also called the "sixth force of Porter's famous model"). We know indeed that banks can make extra profit (with respect to the "normal profit" they would make by supply online services) on their customers due to the switching costs the latter incur if they leave the bank where they are. Therefore, these switching costs can be seen as a complementor to the total value they can earn with their services, in the sense that without it, the total profit they would make will be lower. So the switching costs add value to the customer base of banks and it's why I think they can be seen as complementors.

Finally, a last point I want to stress out to show that switching costs are not "per se" negative is about experience goods and their specificities. Like the digital piracy may increase the profit of artists thanks to the "experience good" property of music songs, the same way of reasoning could be followed to claim that switching costs may be welfare enhancing when dealing with experience goods. A good example is the purchase of a car; before buying it, you don't know the quality and the safety of it. As manufacturers know that, they have an incentive to less invest in the quality of their cars. However, customers that have had a positive experience with their previous car are hence more inclined to buy cars by the same suppliers in order to reduce their uncertainty costs. We can say here that they voluntary lock-in to high-quality suppliers. It follows that customers develop buying patterns such that poor quality cars are less bought than high quality ones. Therefore, manufacturers have now incentives to invest in the production of high-quality cars which will eventually correct the initial market failure known as moral hazard problem.

To conclude, we know that switching costs can be highly detrimental to consumers. But other effects and features have to be taken into account to assess the final effect on consumers' welfare. Consumers can voluntary be locked-in and/or enjoy a lot of utility to buy from this supplier and/or enjoy very low prices before being locked-in. We have thus to balance all this forces to determine the effects of switching costs on consumers' welfare.

Reply

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  Paul Belleflamme 262 Comments
  16/02/2012 • 08:56

  Thanks for these thorough comments. You've got very good intuitions. We'll try to combine these intuitions within a unified model during the lecture. And you're probably right about the car industry. As we explain in a footnote on p. 168 of our textbook (Belleflamme & Peitz, 2010): "Colombo et al. (2000) report that among 20 000 new car buyers in France in 1989, almost half purchased their car
  from the same supplier as before. This may be seen as an indication of brand loyalty resulting in consumer switching costs. However, to the extent that consumers have heterogeneous time-invariant tastes over different car brands before their initial purchase, product differentiation (as analysed in Section 4.2) is an alternative explanation for the high probability of staying with the same supplier." (See Colombo, R., Ehrenberg, A. and Sabavala, D. (2000). Diversity in Analyzing Brand-Switching Tables: The Car Challenge, Canadian Journal of Marketing Research 19: 26–36.)

  Reply

22. *Henriette Beck* 5 Comments
12/02/2012 • 17:03

It seems reasonable on the first sight that banks may charge you higher price up to the value of services they offer and the switching costs their customers would have in case of changing the bank. But real case examples where banks pay new customers a certain amount of money for opening a new account at their bank may challenge the outlined arguments.

My train of thoughts would be the following:
If banks want to lock-in their customers and slow down competition, this new approach of attracting customers would be contradictory. Since the "new" bank would compensate new customers for switching, customers would be incentivized to change banks more often, which in turn spurs competition. As a consequence, switching costs would almost disappear and the value of services is more likely to be the critical factor why customers choose one back over another.

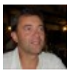
Supported by the example above, I see a more valid argument in the second statement by the Office of Fair Trading: "If switching costs are very low then prices may adjust to prevent customers from switching. So a low level of switching need not imply that switching costs are high."

Reply

-  ***Paul Belleflamme*** 262 Comments
  12/02/2012 • 22:32

  You're totally right in pointing out that banks try to poach customers from other banks. When I was living in the UK, I switched banks to take advantage of a free Eurostar ticket… A the title of my post suggests it, the effects of switching costs on competition are complex indeed.

  Reply

23.  *Alain Strowel* 144 Comments
25/01/2012 • 08:53

Switching costs and lock-in effects are also important for the more well-known issues of standards and interoperability, which are at the core of the tension between intellectual property (as many patents cover technologies incorporated in standards) and competition (refusals to licence a technology under FRAND terms become an issue when the technology is essential or indispensable for interoperable systems or for derived innovation). The issues involved with switching banks and with switching (standardised) technologies are different, but to compare them might at the same time be interesting!

Reply

-  ***Paul Belleflamme*** 262 Comments
  25/01/2012 • 08:55

  I totally agree and I hope that future comments will pick up on your suggestion.

  Reply

Leave a Response