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## Switching costs and market power in the banking industry: The case of cooperative banks

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### ABSTRACT

We investigate the influence of switching costs in banking for the three largest Eurozone countries (France, Germany, and Italy). We use [Shy \(2002\)](#) approach to measure switching costs on bank-level data from 2006 to 2012. We examine whether cooperative banks have different switching costs than commercial banks. We find lower switching costs for cooperative banks, suggesting that their client-based ownership contributes to reduce incentives to bank managers to lock in customers. We analyse whether the level of switching costs influences the market power of banks, and conclude to a positive relation between switching costs and market power.

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### 1. Introduction

Cooperative banks have an average market share of 20% in Europe and can even dominate commercial banks as in France (European Association of Cooperative Banks) These financial institutions are distinguished from commercial banks mainly through their capital holding structures and their branch networks. On the one hand, cooperative banks are not listed on stock exchanges and are held directly by their clients through member shares. Members participate directly in their governance and elect their representatives through general assembly meetings. As a consequence, bank managers have special incentives to take into account the welfare of clients. On the other hand, cooperative banks have developed large and local branch networks from the past, providing financial services to clients and small local firms ([Ayadi et al., 2010](#)). This strong proximity favors tight bank-customer relationships ([Ayadi et al., 2010](#); [Bülbül et al., 2013](#)).<sup>2</sup> A natural question that then emerges from the differences between cooperative banks and commercial banks concerns the potential implications of these differences on bank behavior. [Chiaromonte et al. \(2013\)](#) have shown that cooperative banks in OECD countries promote financial stability while [Ferri et al. \(2014\)](#) observe that cooperative banks in European countries contribute to reduce credit supply volatility.

The major aim of this paper is to investigate whether switching costs differ between cooperative banks and commercial banks for the three major Eurozone countries (France, Germany, and Italy). Switching costs can occur in many markets, as

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<sup>2</sup> See also [Degryse et al. \(2015\)](#) for a recent analysis of the bank-firm relationships.

they appear when consumers have to bear costs through time, effort, or money when switching to other suppliers. There is a consensus in the literature that switching costs are a major characteristic of the banking industry (Degryse et al., 2009).

In banking switching costs include transactional costs related to changing a bank account from one bank to another or to taxes related when closing financial securities earlier than contractually planned. They are also associated with informational costs. Owing to the existence of information asymmetries in the bank-borrower relation, the incumbent bank has better information than any potential competitor because of the long-term relationship between the bank and the borrower. This informational advantage gives the possibility for the incumbent lender to extract profits from locked-in clients (Greenbaum et al., 1989; Sharpe, 1990). If a client wants to switch to another bank, the new bank does not know its quality and will then consider a low risk borrower with greater risk than what the old bank would assess, which results in unfavorable lending conditions. Hence the switching cost is the lost value of the long-term relationship with the old bank. Informational costs can also include the better information owned by a client on its current bank in comparison to other banks, which makes the client reluctant to switch to another bank. As stressed by Klemperer (1995), for any economic activity, switching costs can also be induced by utility losses due to the consumption of another brand because of the uncertainty of the other brands' quality.

We can then wonder whether the governance and high degree of relationship banking of cooperative banks influence the magnitude of switching costs. Two opposing arguments can be suggested based on both key differences between cooperative banks and commercial banks. On the one hand, the specific governance of cooperative banks which are owned by their clients can favor the fact that these banks have lower switching costs for two reasons. First, owners of the bank, have lower incentives to adopt strategies that reduce the welfare of clients, because they are themselves clients. Second, clients who are owners of the bank through the purchase of shares have lower incentives to switch to other banks as their ownership of shares can increase their connection to the bank. On the other hand, the higher degree of relationship banking can result in having highly "locked-in" clients.

There are few studies that measure switching costs in the banking industry. While many have been done for the US banking industry (e.g., Sharpe, 1997; Santos and Winton, 2008), a few studies have been conducted for European banking industries: Shy (2002) on the Finnish deposit market, Kim et al. (2003) on loan markets in Norway, and Barone et al. (2011) on four local loan markets in Italy. However, to the best of our knowledge no work has ever compared these costs between cooperative banks and commercial banks. Therefore we fill a loophole in the literature.

The second objective of this paper is to examine whether the degree of switching costs can help in explaining bank competition. The difference in switching costs between cooperative banks and commercial banks is indeed a major question for the market structure of banking industries in Europe, because it can explain differences in market power of banks among banks and among countries. Several studies have observed cross-country differences in bank market power across Europe (Carbo et al., 2009; Weill, 2013). We can then contribute to explaining these differences by highlighting the influence of switching costs, which is conditional to the composition of the banking industry between cooperative and commercial banks. Moreover Egarius and Weill (2014) have shown a lower market power of cooperative banks relative to commercial banks. Therefore it is of importance to check whether this finding results from a difference in switching costs between both types of banks. Nonetheless, the role of switching costs on the market structure depends on the relation between switching costs and market power of banks. To this end, we investigate empirically this relation for European banking industries.

The influence of switching costs on firms' market power is supported by theory. For a given market switching costs exist if a buyer purchases a product repeatedly and will find that it is costly to switch from one supplier to another (Farrell and Klemperer, 2007). Switching costs then are faced directly by clients when they decide to change suppliers (Kim et al., 2003). In the banking industry, the theoretical literature supports the view that switching costs enhance the market power of banks, with Sharpe (1990) notably showing that a long-term relationship gives the incumbent bank market power on its clients thanks to its informational advantage.

However the empirical literature on the influence of switching costs on market power and more generally on pricing behavior in banking is still debated today. In the US, Stango (2002) has studied the relation between prices and consumer switching costs for the credit card market and finds that switching costs have an important influence on pricing for commercial banks, but have almost no influence on credit unions. In their analysis of local Italian loan markets, Barone et al. (2011) show that banks charge lower loan rates to new clients in line with the expected influence of switching costs on pricing. Using Bolivian credit register data, Ioannidou and Ongena (2010) determine new loan conditions for firms who switch to other banks and find that firms that decide to switch benefit from an average discount on interest rates that are 0.89% lower than loans granted to non-switching firms. In the UK, Zhao et al. (2013) have considered how switching costs can affect competitiveness of banks. In China, Ho (2015) investigates the relation between switching costs and consumer demand for deposits and concludes that lower switching costs favor competition.

To examine these questions, we use data for banks from the three major Eurozone countries (France, Germany, and Italy) for the period 2006–2012. The cooperative banks have a large market share in these three countries, while we have sufficient numbers of cooperative banks and commercial banks to perform a relevant comparison between both types of banks.

We employ the approach proposed by Shy (2002) to estimate switching costs in banking. We choose to adopt this method as it can easily be applied on banking data to provide bank-level measures of switching costs. We measure banks' market power with the Lerner index, which is in line with recent studies (Carbo et al., 2009; Weill, 2013; Egarius and Weill, 2014) so that we can investigate the relation between switching costs and market power of banks to know whether switching costs matter for bank competition in European banking industries.

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