Switching Costs and the Irish Mortgage Market

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Mortgage interest rates are determined by a number of factors; the credit risk associated with lending, operational costs of the bank, cost of capital and competitive environment all impact mortgage rates offered by banks. In this paper, we will evaluate, from an economics of competition policy perspective, the role of switching costs in improving competition in the Irish mortgage market. Mortgage switching has been identified as a 'key enabler' for unlocking greater competition and consumer mobility in the Irish market. At present, switching rates are very low, despite the potential benefits a consumer may obtain from switching their loan provider. Only 2% of Irish consumers switched between 2011 and 2016 (CCPC, 2017).

Introduction

Competition policy plays an influential role in the protection and elevation of consumer welfare under a free market structure. The Central Bank of Ireland and Competition and Consumer Protection Commission have a key role to play in ensuring the efficient functioning of the mortgage market. The CBI in 2017 noted that the competitive environment in the Irish mortgage market has weakened over the course of the last decade. This has allowed lenders to increase margins above the levels expected in a more competitive environment. If new market entrants continue to be rare, and there is a lack of effective competition, lenders will operate within an oligopoly (McQuinn & Morely, 2015). The CCPC in their report 'Options for Ireland's Mortgage Market' outline how a reduction in the cost of secured mortgage lending is possible through the improvement of lender competition. The lowering of switching costs in the market has been identified as one way in which regulators may increase competition.

Types of Switching Costs

In many markets, consumers who have previously purchased from one firm face costs in switching to a competitor's product, even if the two firms' products are identical (Klemperer, 1995). Klemperer (1995) identifies many different switching costs. Among them are 'transaction costs of switching suppliers', 'uncertainty about the quality of untested brands' and 'psychological costs', all of

which may be applied in the context of the Irish mortgage market.

As part of a report published in April 2017, the CBI examined consumer perceptions, attitudes and experiences of mortgage switching. In the same year, the CCPC carried out further research in this area. The results obtained from the consumer focus groups used in these studies can be used to identify distinct switching costs present in the Irish mortgage market.

(1) Transaction Costs

These studies showed that consumers find it difficult to evaluate the differences between mortgage offerings present in the market. Limited knowledge is compounded by the complexity of mortgage products. Besides the basic rate, term and bank-specific features of a product, effectively analysing a mortgage offering requires the consumer to think across multiple time and cost dimensions. The prevalence of variable rates in the Irish market adds to the complexity faced by consumers in effectively forecasting gains from switching. Consumers incur transaction costs in evaluating competing offers, closing their existing account and completing documentation. The hassle involved with moving data or files from one institution to another is an immediate consideration. Eldin and Harris (2013) call this 'data portability' and cite it as an important determinant of transaction costs.

(2) Uncertainty

Focus group discussion facilitators noted a general sense of consumer fear and uncertainty surrounding mortgage switching. Consumers are uncertain about the quality of untried lenders, and associate switching with financial risk. Consumers are risk averse and prefer to remain with a familiar loan provider. For many, the perceived risk outweighed any potential reward. Consumers were sceptical about new entrants, unsure of whether these banks were committed to the Irish market. It can be argued that the financial crisis, and the tracker mortgage scandal may have damaged consumer confidence in the Irish banking sector. This may add to consumer's apprehension in dealing with creditors.

(3) Psychological Costs

Klemperer (1995) outlined how consumer tastes evolve to favour the brand they are using. In behavioural economics, this is called ownership bias. Some customers cited the reason for doing business with a particular bank as linked to the fact that their parents use that bank (CCPC, 2017). A second bias which may serve as a switching cost is the observation that humans discount future gains (which here would be savings on mortgage repayments) hyperbolically (O'Donoghue &

Rabin, 1999). The cost of finding an improved mortgage offering is incurred by the consumer immediately. The benefits associated with switching accrue to the consumer slowly over a long future period. It has been shown that consumers discount these 'gains' at a very high rate, inconsistent with the standard economic assumption of rationality (O'Donoghue & Rabin, 1999). This significant consumer bias may partly explain why the average mortgage consumer is failing to accurately forecast gains from switching.

Switching Costs and Market Competition

Barriers to switching mean that banks face a trade-off between investing in market share (for example, by charging a low interest rate that attracts new customers) or harvesting profits by charging high rates, which allow them to capitalise on existing market share. Klemperer (1995) finds that a firm's incentive to exploit existing customers dominate their incentive to attract new ones. This leads to higher prices in markets with switching costs. High switching costs can create barriers to entry and barriers to expansion for rivals (Eldin & Harris, 2013). Furthermore, high switching costs may provide the conditions for firms to act as monopolists within their individual share of the market. McQuinn and Morely (2015) suggest that a lack of competition in the Irish mortgage market may be why decreased ECB rates have not been passed on to consumers.

Klemperer (1995) describes the mechanism by which a firm may act as a monopolist against its own customer base. He illustrates this using a duopolistic model. Let α represent the fraction of consumers that have previously taken out a mortgage with bank A. They incur switching costs in switching to bank B. The complementary fraction bought from bank B, $1 - \alpha = \beta$. If s is large enough, then the unique non-cooperative Nash equilibrium in price competition yields firms joint profit maximizing outcome. The reason is that bank A cannot attract any of B's customers without lowering prices below B's price. Large price cuts give up more profits on it's already captive customers than it gains by stealing B's customers. Bank A does better to act as a monopolist within its share of the market. The current conditions present in the Irish market make it more likely to observe this type of behaviour. The number of firms decreased following the financial crisis, and the Herfindahl-Hirshman Index has increased to just below 2200, surpassing the benchmark 1800 level (CCPC, 2017). Market concentration is high. As well, the pattern of market share is relatively symmetrical, which Klemperer (1995) cites as a condition facilitating monopolistic behaviour in a market with switching costs.

It is helpful to view every new cohort of 'first-time buyers' as a separate market. There may exist fierce competition to capture these customers, build up market share and use this expanded consumer base to increase profits. If we treat new mortgage customers as a separate sub-market, analysis of the competition mechanisms at work within the market become easier to distinguish.

In 2010, an American court ruled that Microsoft had 'acted anticompetitively to increase, maintain and exploit high switching costs' (Eldin & Harris, 2013). 'The Microsoft Case' is an important example of the application of anti-trust law in the context of switching costs. These legal findings suggest that perhaps switching costs are less of a 'grey area' than they may appear to be. Although no such case has come before Irish courts, it is likely that Irish banks are aware that high switching costs and monopolistic actions against their own consumer bases can indeed lead to legal penalties.

What is lacking in the CCPC's report is a discussion of the distinction between 'inherent' and 'strategic' switching costs. Inherent costs occur naturally in the market, whereas strategic costs are created or elevated by market players (Eldin & Harris, 2013). This distinction is important when analysing whether a firm has attempted to strategically raise switching costs to act as a monopolist against its own customer base. Firms can increase the complexity of their products to raise switching costs. The proliferation of 'loyalty discount' and 'cashback' offerings available on the Irish market may be viewed as sophisticated attempts by banks to manipulate consumer behaviour, making comparison and evaluation of competing offers an increasingly complex task. If Irish banks raise the complexity of their products to lock in market share, is it possible to equate this to indirectly collusive behaviour? Klemperer (1995) outlines how the existence of switching costs may lead firms to simultaneously and non-cooperatively raise those switching costs. Klemperer argues that switching costs facilitate collusion through the dividing-up of market share into defined sub-markets of consumers who bought from different firms. This provides 'focal points' for tacitly collusive division of the market. However, while it may appear that high switching costs are evidence of collusion, this intuition does not seem easy to formalise (Farrell & Klemperer, 2001). The CCPC makes no reference to this being an issue, and focuses on how regulation may be implemented that would encourage mortgage switching.

Considerations for Irish policy

Switching costs have been identified by both the CCPC and CBI as a significant barrier to effective competition in the Irish mortgage market. It has been shown that consumers face difficulty in accurately evaluating competing mort-

gage offerings. This is exacerbated by the complexity associated with additional product features. The Fair Mortgages Campaign and some politicians have called for cash incentives to be banned. However, it is difficult to see how this could be prevented without the introduction of new legislation, and whether this type of legislation would be capable of being implemented at all.

Cass Sunstein and Richard Thaler, in their influential book 'Nudge', attest to the power of behavioural economics and it's role within public policy. Acknowledging a general dislike (from both consumers and industry) of excessive government intervention, they advocate an approach they call 'liberal paternalism'. It is evident that consumers are often not behaving rationally in the market. One suggestion is to have specific nudge points over the course of the mortgage life cycle, where switching is presented as an option to the consumer. The 'hassle' factor linked to mortgage switching may be significantly reduced through the introduction of e-conveyancing. Costs associated with evaluation/learning may be reduced through informational campaigns and the promotion of mortgage comparison websites and use of independent financial advisers.

Even upon successful implementation of programs to encourage mortgage switching, it is unlikely that a dramatic increase in switching would be observed due to the prevalence of tracker mortgages. Although trackers are now no longer available on the market, they account for 48% of the credit advanced to Irish resident households for home purchases (CCPC, 2017). This significantly reduces the pool of potential switchers. Tracker mortgage customers pay less in mortgage repayments, as the ECB rate is at an historically low level. This is a drain on bank profitability. Higher rates are passed on to other customers, in to compensate for the losses banks are making on trackers. This should be kept in mind when evaluating competition in the Irish mortgage market.

Conclusion

A decrease in switching costs has the potential to elevate competition in the mortgage market. An increase in competition may facilitate a lowering of the cost of credit, encourage new market entrants and increase the quality of customer service. Switching costs come in many forms, and may act as a significant barrier to effective competition and consumer mobility in the market. It can be argued that the presence of switching costs in the Irish mortgage market leads to banks acting as monopolists against their own customer base, and a simultaneous raising of switching costs by Irish banks may equate to tacit collusion. The CBI, Department of Finance and CCPC have a key role in encouraging increased levels of mortgage switching. These organisations should consider exactly how to decipher

whether banks are engaging in a strategic, or a collusive raising of switching costs. Switching is a facet of Irish mortgage policy ripe for intervention, and should be an immediate target for policy-makers.

References

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