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Working Party No. 2 on Competition and Regulation

ROUNDTABLE ON COMPETITION AND REGULATION IN RETAIL BANKING

-- Hungary --

16 October 2006

The attached document is submitted by the delegation of Hungary to the Working Party No. 2 of the Competition Committee FOR DISCUSSION under Item III of the agenda at its forthcoming meeting on 16 October 2006.

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1. Introduction

1. Before the transformation into a two-tier banking system in 1987, retail banking was the monopoly of a state-run company in Hungary. Although new entries and the development of financial services resulted in a fundamental transformation of the market, some aspects still reflect the inherited market power of the former monopoly. For instance, the market for sight deposits is still highly concentrated, the Herfindhal-Hirschman index (HHI) stood above 2500 in June 2006. The payment card business is even more concentrated. This is illustrated by the fact that the concentration (HHI) of commission income related to the payment card business exceeded 4100 in 2005. Consequently, the impact of technological development should be assessed against this background.

2. Although a concentrated market structure does not necessarily result in non-competitive pricing practices, some empirical evidence shows insufficient competition in various retail market segments (at least in recent years). Analyzing the pricing behavior of banks in different sub-markets in a study prepared for the GVH, Várhegyi (2003)[1] finds that the elasticity of household lending rates (to money market rates) is very low, which enables banks to earn oligopolistic rents. Moreover, the elasticity of household deposit rates was found to be low and negatively related to the market shares of banks. Similar results have been obtained by Móré and Nagy (2004)[2] in consumer lending markets. Using a "conjectural variation" model, they found that the consumer credit market is characterized by a low degree of competition, i.e. between Cournot equilibrium and perfect collusion. They also provided evidence that a low level of competition, coupled with a relatively low price elasticity of demand, had allowed banks to earn high oligopolistic rents in the period under investigation.

3. There are numerous factors explaining the behavior of the banks on the market. The most important factors include switching costs, financial literacy, access and the regulatory environment.

2. Switching costs

4. The GVH regards the possibility of switching as an essential component for realizing the benefits of competition in financial markets. The ability to switch between financial service providers represents an important contribution to a healthy market structure and thereby to the proper functioning of financial markets.

5. Customer mobility is one of the most important constraints of market power as it ensures that products and services offered with better conditions by new entrants or incumbents could actually reach customers. Lacking this mobility, financial service providers could exercise their market power to the detriment of consumers. Higher consumer mobility results in more elastic demand, which should promote more intensive competition.

6. The GVH has been involved in two customer surveys in this topic, to identify customer preferences and attitudes regarding switching. The first survey with the general goal of exploring consumer habits in financial markets was carried out in 2000-2001, and contained several questions on switching. A more recent customer survey focusing on certain issues of switching is being finalized in September 2006, with the preliminary results already available.

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1 Várhegyi, Éva (2003), "Bank Competition in Hungary", *Közgazdasági Szemle*, pp. 1027–1048, December 2003 (in Hungarian)

2 Móré, Csaba and Nagy, Márton (2004), "Competition in the Hungarian Banking Market", MNB Working Paper 2004/09

2.1 Main results of the 2001 survey[3]

7. According to the 2001 survey of the GVH, only 16% of the representative sample has ever switched banks. A major factor prompting switching was the opening of a new branch by another bank at a favorable geographic location offering better conditions. Other important factors were loss of customer trust and the cease of operations by the previous bank.[4]

8. On the other hand a well-established, long-term relationship with an existing business partner meant in itself a very important factor in discouraging customers in switching. The fact that the lack of a branch office in the given town also played a significant role could indicate the insufficient development of retail banking network at that time. This idea is also underpinned by the expansion of retail banking outlets of credit institutions since then, some of them already offering a competitive alternative for the incumbent.

2.2 Findings of the 2006 survey[5]

9. A more recent customer survey, based on a questionnaire designed by a working group of the National Bank Of Hungary (Magyar Nemzeti Bank, MNB) and the Hungarian Financial Supervisory Authority (Pénzügyi Szervezetek Állami Felügyelete, PSZÁF) was carried out in 2006, in order to identify the most important obstacles of switching between financial service providers.

10. 38%of the respondents opened a new current account in the last five years: however only 13% of the total sample can be considered as real switchers. The study defined current account switchers as customers who have had a current account previously, and opened a new account either with the abolition or the maintenance of their former account.

11. Not only is the share of actual switchers moderate in the population, but also the inclination to switching is very low. 85% of the population did not even ever consider switching current accounts, and only 1% considered switching very seriously

12. The most important reasons mentioned spontaneously by the respondents for their reluctance to switching were the following: being content with the current product they use (39%), the lack of need for an additional current account (23%) and halting one current account sufficient (12%).[6]

13. The results might point to the conclusion that respondents are not aware of the benefits from having a better product in the field of current accounts. Most of them are satisfied with their current financial service provider, however, they are not able to compare the costs and benefits arising from switching.

14. One reason for the overall disinterest in switching is the relatively low usage of financial products. Although 81% of the respondents hold a payment card, 33% of them never used it for conducting

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3 The 2001 survey is based on the responses of 1.000 Hungarian residents over the age of 18. The sample of the survey reflects the Hungarian population by age, gender, education, region, and size of locality. The interviews were conducted face-to-face in people’s home.

4 Loss of consumer trust can be originated in some bankruptcy cases mostly in the early stages of development in the financial sector.

5 The 2006 survey is based on the responses of 800 Hungarian residents over the age of 18. The sample of the survey reflects the Hungarian population by age, gender, region, and size of locality. The interviews were conducted face-to-face in people’s home.

6 These responses are based on the assumption that opening a new current account while maintaining the old one is also considered as switching.

payment transactions and a further 16% used it only once a year or even less frequently. The ratios of people using telephone banking, mobile banking and internet banking services are all below 10%. In money transfers, recurring tasks are more popular than individual ones: 34% of the respondents use standing orders, while 25% use direct debit.

15. The cost of the current account service is seen as high or very high by 33% of the population, but only 17% believes that costs charged by their bank higher than those charged by other banks. Transparency seems quite limited in the market as 28% of the respondents could not compare their costs with other financial service providers. 13% of the respondents stated that it is because costs of these services are not comparable at all – the same ratio, 13% found them perfectly comparable, while 46% sees them as partly comparable.

16. Respondents were also interviewed about their perception of the switching process. On the basis of the total respondents, 40% voted for an easy process, while 32% viewed switching as complicated, or at least relatively complicated (with a very high proportion, 28% being unable to answer this question). The most commonly named reasons for considering switching complicated were non-billable costs: the administrative burden when closing an account is seen most frequently as an obstacle in switching, followed by the disclosure of the new account number at several financial partners and the memorizing of new access codes.

17. The questionnaire has also included some questions on other dimensions of switching financial service providers: the possibility to switch could not only be an important aspect of competition in the case of current accounts, but also for other financial services such as credits, where re-financing often could be reasonable. However, 37% of the respondents having some kind of consumption credit have not even heard of the possibility of re-financing, and only less than 10% has considered switching between banks. Ensuring the possibility of switching between credit products is an indispensable feature of properly functioning credit markets: the GVH has been receiving numerous complaints about too high early repayment charges which supposedly hinder competition, thus investigations have been opened in this field.

2.3 Switching from a competition aspect

18. The results of the above mentioned surveys show that the overall maturity of financial markets plays an important role in switching. With the limited use of financial services switching may seem a lot easier, since most of the administrative and non-billable costs are not present. In addition to this, customers might be less sensitive to cost differences if having to pay only for a very basic service.

19. However, the lack of motivation is also exacerbated by the fact, that market transparency is quite limited due to very complex financial products. Customers are often not in a position to correctly evaluate offers from different financial service providers. Certain tying and bundling practices might constitute additional obstacles for customers in making the right choice between the numerous financial service providers. To increase customer awareness and promote market transparency, several actions shall be taken in the field of switching as well.

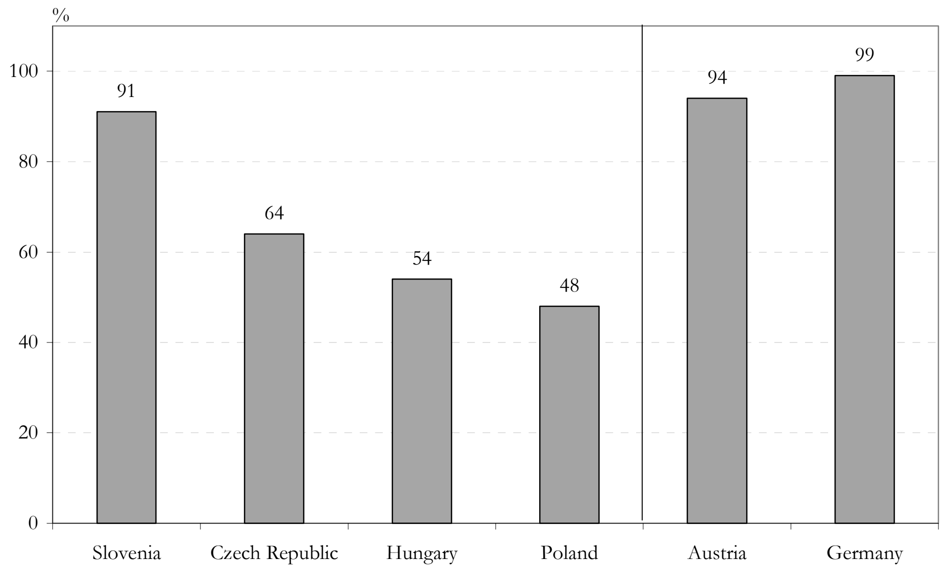
20. Following the recent survey, the GVH is planning to open a sector investigation in the field of switching where experts from the MNB and the PSZÁF are also expected to provide contributions. Based on a survey to be sent to banks this year, some bank products (current account and some credit facilities) are to be examined from the aspect of transparency and the possibility of switching. On the basis of this work, some regulatory recommendations are to be formed to increase market transparency.

3. Financial literacy

21. Technological development is considered to have a positive effect on competition in Hungary. Rapid expansion of new distribution channels and easier access to retail banking products (e.g. credit scoring systems) brought about significant advantages to customers and were generally beneficial to competition in banking markets. However, despite the rapid technological development in retail banking during the past decade, the behaviour of bank customers appears to adjust relatively slowly. According to survey results, 82% of customers (with bank relationship) carry out their banking transactions in bank branches whereas "remote banking" channels (telephone, mobile banking, Internet) are used by less than 10% of customers.[7]

22. Low financial literacy also contributes to the sub-optimal functioning of financial markets. An important manifestation of this is the relatively moderate share of customers with existing bank relationships in the population, compared to more developed EU-countries. According to international customer surveys (GfK), the proportion of customers with bank accounts in the population is still rather low in the new EU Member States benchmarked against financially more developed EU countries (with the exception of Slovenia). For instance, this proportion is only 54% in Hungary compared with 94% in Austria. This "development gap" is even higher in the case of more sophisticated banking products and distribution channels (such as online banking).[8]

Proportion of adults with a bank account in selected CEE-countries and in Austria and Germany



23. Another example of limited financial literacy can be observed in consumer lending markets. Since retail lending started to pick up at the end of the 90s, customers are still at an early stage of their learning curve. At the first stage of development in the consumer lending market, customers showed low interest rate sensitivity. Demand for consumption credit remained strong despite extremely high nominal interest rates (and total credit costs, APRC).[9] The real value of newly granted consumption credit and the

7 Source: GfK, CEE Newsletter 02/2006, July 2006.

8 For a more detailed elaboration on this see the section on switching costs.

9 See MNB (2004). Magyar Nemzeti Bank (2004), Report on Inflation, February 2004

real total credit cost (APRC) correlated positively between 1998 and 2003 (MNB, 2004).[10] Possible underlying motives for the lack of price sensitivity included the establishment of and improvement in the supply-side conditions of consumer lending, hence the easing of liquidity constraints. This suggests that, given the relatively low amount of installments, in the period under investigation, most clients seemed to have paid little attention to high interest and additional costs.

24. Measures to counter the problems created by low financial literacy can be divided into short-term and long-term ones. Short-term measures aim at increasing market transparency: banks are obliged to publish the APRC in order to make conditions more comparable for customers (since 2004). Moreover, the Hungarian Financial Supervisory Authority started to regularly collect and publish information related to the conditions of retail banking products. Looking at longer-term initiatives, the PSZÁF and the MNB have launched a joint project in 2006 aiming to reduce the 'information gap' of retail customers. The main goal of this project is to integrate the teaching of financial basics into school education.

25. In sum, the potential negative effects of technological development on retail banking competition seem to play a less significant role in a newly developing banking market, such as in Hungary. Concerns regarding the potential anti-competitive effects of changes in the technology of production in retail banking are less pronounced compared with other sources of market power.

4 Access

4.1 Access to credit information on retail customers

26. In retail lending the lack of a commonly accessible database on proper debtors may put some market players at a competitive disadvantage. Not only does the lack of this database result in higher risk premia, but it also creates information asymmetry between incumbents with a larger database and smaller players/new entrants. For both reasons, financial regulators have repeatedly called for the introduction of so-called 'positive list information systems', which has not yet materialized because of data protection concerns.

27. However, as mentioned earlier, empirical investigations in relation to the Hungarian banking market suggest (Móré-Nagy, 2004) that high margins in consumer lending are not only the result of higher risk premia but also the result of banks' oligopolistic pricing behaviour. Thus, it may be argued that the lack of a positive list debtor information system on households contributes to an environment where banks "overcharge" customers for default risk.

4.2 Access to key transaction systems

28. In general, as the overseer of major payment and settlement systems, it is an important goal for the central bank to avoid that the potential limitation of access to systems or differential treatment of customers not be a tool for restricting competition.

29. Accordingly, payment and settlement systems should have objective and transparent membership criteria which ensure free and non-discriminatory access to these systems. This principle is fulfilled in a special way in the case of the two most important systems (VIBER and GIRO).[11] According to the Act on Credit Institutions, mandatory membership is required for credit institutions providing payment services in

10 See MNB (2004).

11 VIBER is a real-time gross settlement system, mainly designed to process large-value transactions. BKR (Interbank Clearing System) is a „hibrid" system, mainly used for processing lower value customer transactions.

at least one of these systems. This means, that membership criteria do not include special financial conditions. For instance, in the case of VIBER, which is operated by the central bank there is no entrance fee and transaction fees are uniform. One membership criterion that may cause some competitive or cost disadvantage for smaller institutions is the membership in the SWIFT system.

30. Although few signs of competitive disadvantages can be detected in the case of payment and transaction systems, the same cannot be said on the pricing practices of payment transactions by banks. Experience shows that the positive effect of an efficiency and competition enhancing pricing policy by the regulator does not always reach the final consumer.[12]

31. Signs of market power can also be observed in case of cross-border, small-value euro transfers. Most Hungarian banks joined in some form the pan-European settlement system (STEP2), which has been operating since April 2003 and which processes transfers below the value limit of 50,000 euros. This system allows a faster and cheaper processing of transactions compared to using traditional correspondent banking relations. However, the majority of customers are not informed about this opportunity, as banks do not indicate the transactions rates in their list of conditions, and thus the principle of fee transparency is harmed.

5. Merger and acquisition regulations

32. The rules governing any kind of merger and acquisition activity in Hungary are laid down in the Competition Act (Act 57 of 1996 on the prohibition on Unfair and Restrictive Market Practices) and in the Credit Institutions Act (Act 112 of 1996 on Credit institutions and Financial Enterprises).

33. The Competition Act does not contain provisions that would put foreign competitors to a competitive disadvantage. Chapter VI of the Competition Act contains merger rules, establishing the authorization of the GVH for transactions exceeding certain turnover thresholds: these rules do not discriminate in favor of domestic acquirers.

34. The Credit Institutions Act establishes the authorization powers of the Hungarian Financial Supervisory Authority. The PSZÁF’s powers for the merger control of financial institutions shall not or substitute the authorization of the Hungarian Competition Authority in any way or form.

35. According to the Credit Institutions Act, the rules governing the foundation of credit institutions shall be applied to mergers as well. According to these rules, if there is a foreign-registered financial institution, insurance company or investment company among the founders (acquirers) who wishes to acquire a qualifying participation, a statement of the competent supervisory authority of the country of origin shall also be attached to the application for authorization stating that the enterprise conducts its activities in compliance with prudential regulations.

6. Relationship between banking regulator and competition authority

36. Banking activity is generally overseen by two authorities in Hungary: the Hungarian Financial Supervisory Authority (PSZÁF), and the National Bank of Hungary (MNB). The PSZÁF performs mostly authorization and supervisory functions. In the field of banking, most of its duties are determined by the Act on Credit Institutions. The authorization of the PSZÁF is required for providing most of the financial

[12] In particular, a continued reduction in VIBER fees charged to banks by the MNB in recent years was usually not passed through to customers. Thus, banks often leave their fees unchanged following changes by the central bank, keeping the price level of this service artificially high. See: Report on Financial Stability, Magyar Nemzeti Bank, April 2006.

services and to the most important organizational and structural activities (e.g. foundation, takeover, commencement of operation) of credit institutions. In clearing operations and money processing activities the authorization rights lie with the MNB The MNB has consultative rights in authorizing financial transaction services, in issuing electronic money and cash-substitute payment instruments and performing related services as well as money transmission services. The MNB is also responsible for macroprudential market supervision, as it maintains and promotes the stability of the financial system and contributes to the development and smooth conduct of policies related to the prudential supervision of the financial system.

37. Cooperation between the banking regulators and the competition authority plays a very important role in competition law enforcement. This cooperation materializes in several forms like data providing, information exchange and even common projects.

38. In cases concerning the financial sector one of the most important data sources for the GVH are the financial regulators since one of their tasks is to collect market information . Besides the data, experts from the financial regulators also share their views on certain aspects of cases on request.

39. The GVH also has a consumer protection unit, and there are numerous complaints that are received parallelly both by the GVH and the PSZÁF. There is an increased cooperation in these cases, and the division of labor and the information exchange has improved quite considerably in recent times.

40. There is also a formal cooperation agreement in force between the GVH and the PSZÁF establishing high-level meetings and information exchange between the authorities. In order to further strengthen this cooperation, this agreement is to be revised this year.

41. Furthermore, the GVH is about to launch a sector investigation in the field of financial services about switching. During the preliminary work, a working group was set up to identify the most important issues the sector investigation is targeting. Numerous experts from the MNB and the PSZÁF participated in this working group, formulating a questionnaire for consumers and helping in finding the possible obstacles in switching financial services providers.

42. This joint working group was an excellent opportunity for experts from the different authorities to exchange their views and it has also contributed to deepen cooperation in other fields to a considerable extent.

43. The GVH regards this cooperation as very useful and absolutely essential for its everyday work. The coordination of activities by the different authorities overseeing the financial sector could largely contribute to its better functioning.

7. Competition law and banking

44. In Hungary, competition law applies to banking as well. There have been some mergers in the sector, but due to their limited size they did not raise serious anti-competitive concerns so far.

45. The GVH is also active in examining the possible anti-competitive conduct of financial service providers. Most recently, in 2004-2005 the GVH has conducted a sector investigation on the market of home mortgage loans.

46. On the market of home mortgage loans, the level of interest rates offered by banks, steadily growing profits and interest rate margins significantly exceeding EU-average pointed toward the fact that effective competition in the field of „price competition" may be limited.

47. The home loans market was rapidly growing during the investigation period The market expansion has been realized at a rather high concentration level (70% of the market is controlled by 5 market players, and 52% is in the hands of a single market player) albeit the HHI for banking groups has decreased in the investigation period. As a result of government subsidies, the market kept growing with the appearance of more and more players; and as a consequence of this, competition at the home loan segment has become more intensive. Compared to other aspects of competition, in price competition this phenomenon could hardly be noticed during the investigation period, for which regulation and government subsidies are the main explanation. However, the market is yet to reach the level of effective competition, because the price-cap established on government subsidized loans acted as a benchmark price for credit institutions.

48. The GVH has made several recommendations as a result of the sector inquiry aimed to supervisory authorities and the Hungarian Bankers' Association. The suggestions pointed toward the need for increase in market transparency: information for the consumers have to be made accessible in a clear, understandable way ensuring that customers will have the ability for a meaningful comparison of the various offers by the banks. A possible way to achieve this would be via self-regulation through the Hungarian Bankers' Association. The GVH also regarded it necessary to take a step forward to the appropriate fulfillment of customer protecting civil organizations' opportunities at the fields of right and interest assertion. A further finding was the necessity to examine general terms and conditions applied by credit institutions from the aspect of whether unilateral benefits in favor of the credit institution applied in sample contracts are harmonized to special customer protection regulations appearing in civil law (unfair contract conditions).