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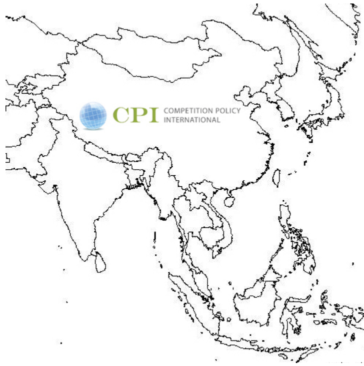

The pitfalls of regulating retail banking overdraft charges

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In recent years, regulators in the UK, Germany and elsewhere in Europe have increasingly voiced concerns over high borrowing costs on consumer current accounts resulting from overdrafts. Interest rates regularly exceed 10% and are sometimes considerably larger than banks' costs of funds. The UK Office of Fair Trading (OFT), in particular, has repeatedly argued that competition between retail banks on overdraft interest rates is not effective, especially with regard to unauthorized overdraft charges. Currently, regulatory intervention is considered both in the UK and Germany, with market studies and regulatory initiatives under way.

Critical views of current account interest rates in retail banking have received some support from an emerging literature in behavioural economics. This literature argues that consumers often underestimate the likelihood with which they will require access to a credit line in the future. Under such circumstances, competitive market pressures on interest rates are likely to be weak, as consumers who choose a bank pay less attention to the size of overdraft fees and more attention to other charges (e.g., annual fees). Taken at face value, this behavioural trait would seem to suggest that governments should set price caps on overdraft charges to stop banks from "exploiting" consumers who are naïve about their future borrowing behaviour. Through interest rate caps, consumers can purportedly be prevented from the negative consequences of lock-in with banks that exert market power through excessive overdraft fees.

A closer look, however, reveals that it is not so obvious that such price cap regulations will necessarily make things better for consumers. A recent study on overdraft charges that was commissioned by the German Ministry for Consumer Protection has again confirmed that cross-subsidization between retail banking services is ubiquitous. In particular, basic current account services are regularly offered below cost (indeed, sometimes at no cost at all, as is the case with free current accounts). Once one understands that competition between retail banks takes place over *bundles* of services with varying degrees of cross-subsidization, it

also becomes clear that regulatory interventions on subsets of those services will have adverse consequences for other products.

In particular, basic economic principles imply that regulatory reductions in overdraft charges will induce competing banks to increase their current account fees in response to regulation, in order to compensate for lower returns on interest. Recent research has shown that this waterbed effect generally leads to increases in the price on previously subsidized products, and under certain circumstances may even lead to higher overall charges for consumers post-regulation. Certainly, such a waterbed effect has been experienced in other industries where subsets of product bundles were regulated. For instance, the recent regulatory reduction in interconnection charges for mobile telephony in Europe spawned considerable increases in standard charges.

A second concern is that forced reductions in interest rates are likely to induce banks to cut credit lines for lower income consumers. Since this customer group has a considerably higher risk of default, extending overdraft credit to them is only commercially viable if interest rates are sufficiently high. In the public discussion of overdraft rates, low-income groups are often presumed to be the primary sufferers from high interest rates. This perspective masks two important facts, however. First, a large proportion of unemployed and low-income consumers (39% in Germany, for instance) do not have access to an overdraft facility in the first place—even at today's interest rates. Extending credit to these consumers may often simply be too risky for banks. Second, the social benefits of overdraft facilities are particularly large precisely when consumers face temporary financial distress (e.g., because of recent unemployment). In such situations, current account overdrafts permit access to badly needed liquidity. It is therefore neither surprising nor undesirable that overdraft facilities are more commonly used by consumers who are in financially difficult situations. To the extent that forced reductions in interest rates make it less profitable to supply low-income consumers with temporary liquidity, the benefits of regulation for this consumer group are perhaps less obvious than is sometimes presumed. Indeed, the wisdom of cutting consumers who are in desperate need of short-term funds off credit markets seems

questionable (not to speak of driving them into dependency on less efficient unregulated forms of non-bank lending).

Finally, for those consumers who do get access to a credit facility after regulatory intervention, a forced reduction in charges may well inhibit, rather than propel, a responsible handling of credit. If naiveté and lacking precaution in taking safeguards against the future need for credit is the primary problem we are facing (as is argued by proponents of regulation), then a reduction in interest rates may actually worsen the problem. Indeed, in a recent paper I show that socially optimal interest rates generally exceed banks' expected refinancing costs when consumers are naïve or ignorant about their future likelihood of requiring access to credit.

Specifically, experiencing high charges for overdrafts induces consumers who would otherwise take insufficient care in managing their liquidity to make more responsible financial decisions (e.g., by holding sufficient liquidity on their accounts or by postponing purchases they cannot currently afford). When consumer foresight is limited, a "skewed" price structure with low annual fees and high overdraft charges is therefore a market response that aligns biased consumer perceptions with the true costs of borrowing. In essence, high overdraft charges provide a financial incentive for myopic consumers to improve their ex-ante financial dispositions and can thereby benefit social welfare.

To be sure, none of this is to say that "there is no problem in overdraft lending." Lack of consumer information and myopic borrowing patterns can be the cause of considerable personal harm. Retail banks carry a responsibility to work with governments to alleviate market inefficiencies and to ensure sufficient transparency so consumers can make informed and responsible financial choices. However, this is not primarily a question of competition. As the European Commission's Retail Banking Sector Inquiry has noted, retail banking markets are very competitive in most European Member States. When considering ways to improve the efficiency of current account markets, it is therefore wise not to throw out the baby with the bath water. In particular, overambitious government

intervention in market prices is likely to involve adverse consequences that should lead us to pause before viewing government price setting as a panacea against behavioural distortions. In view of the social costs of regulation and compliance, softer regulatory measures (such as transparency provisions and consumer information) may address the problem at hand more effectively than replacing market outcomes with government-imposed "efficient" allocations.

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