

Policy Brief



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Paying for banking services: What determines the fees?

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The problématique of retail bank fees

In spite of an existing extensive body of empirical papers on the determinants of bank interest rates, very few empirical studies have dealt with retail bank fees (fees charged by the bank to individual clients). Why is this happening and why are there so few empirical studies explaining the nature of retail bank fees?

It appears that the answer to this question lies in the lack of data availability. Even in the case of the U.S., it often seems impossible to obtain quality data on retail bank fees of the size and detail level necessary for rigorous empirical analysis (Hannan, 2006). In addition, the data restriction caused by a high degree of heterogeneity in bank fees and different cross-subsidizations make it difficult to implement an appropriate approach in any comparison across different countries.

According to Brewer and Jackson (2006) and Shaffer (2004), there are two main competing theories on the relationship between industry concentration and pricing: *the Structure-Conduct-Performance (SCP) hypothesis* and *the Efficient Structure hypothesis (ES)*. What are those two hypotheses about?

The Structure-Conduct-Performance (SCP) states that market performance depends on various elements of market structure such as entry conditions, market concentration, and the number and size of firms as well as different forms of firm conduct and

strategic behaviour such as capacity utilization, advertising, and collusion. Thus, firms in more concentrated industries will earn higher profits than firms operating in less concentrated industries, irrespective of their efficiency.

Our empirical analysis of cross-country determinants of bank fees is made possible by the availability of a unique dataset on bank fee levels in five Central European countries with similarities that makes the comparison easier: Austria, the Czech Republic, Hungary, Poland, and Slovakia.

The Efficient Structure (ES) hypothesis says that an industry's structure arises because of superior operating efficiency by particular firms. It is based on the premise that firms with low cost structures increase profits by reducing prices and expanding market shares. Hence, a positive relationship between firm profits and market structure exists due to the gains made in market share by more efficient firms. In turn, these gains lead to increased market concentration. This suggests that increased profits accrue to firms with greater efficiency and not because of collusive activities (Molyneux and Forbes, 1995).

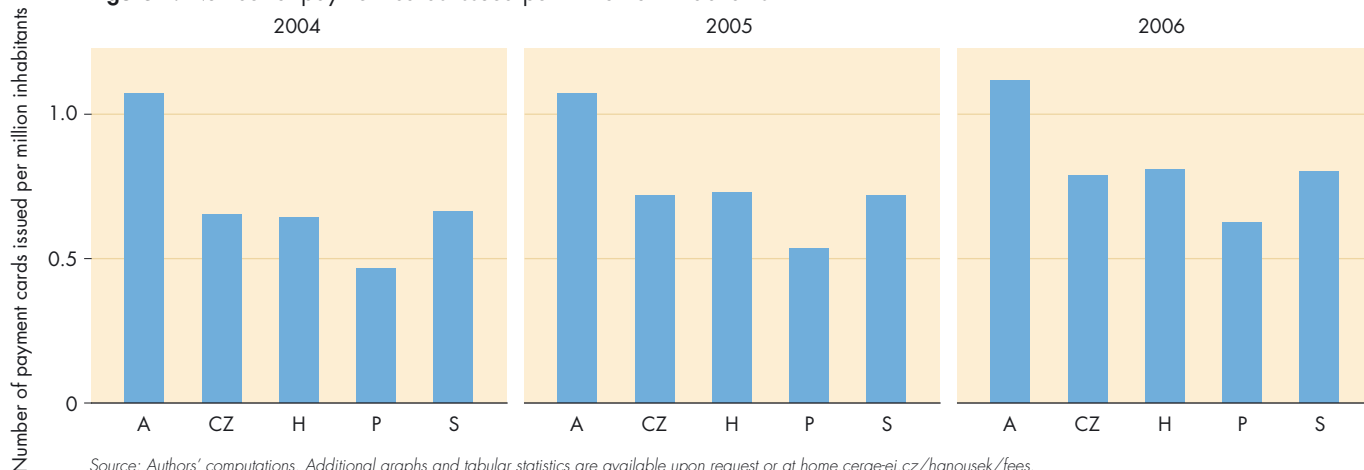
When it comes to the banking industry, there seems to be a negative relationship between deposit interest rates and concen-

tration, which supports the SCP hypothesis. This implies that among the most likely supply-side factors affecting the vast differences in bank fees from country to country are bank costs, market competitiveness, and the extent and form of banking industry regulation. Among demand-side factors, cross-subsidization (banks trying to compensate for losses from charging one group of clients less while charging more to another group) between different bank products is a possibility. In other words, banks try to maximize the benefits from a pool of clients with given demand characteristics.

The unique dataset

Our empirical analysis of cross-country determinants of bank fees is made possible by the availability of a unique dataset on bank fee levels in five Central European countries with similarities that makes the comparison easier: Austria, the Czech Republic, Hungary, Poland, and Slovakia. The socio-geographic region formed by these countries has several important advantages for our purposes. First, these countries are characterized by significant differences in the maturity of their banking sectors. When compared with Austria, a traditionally strong banking country, the other four countries are still in the process of gradually developing their banking sectors. This might be shown on the example of payment cards (as an approximation of advanced use of banking services) issued by banks in

Figure 1: Number of payment cards issued per million of inhabitants



the countries in question (see Figure 1 that follows).

Second, since most of the geographic region in our dataset shares a common history as part of the Austro-Hungarian Empire, these Central European countries form a compact group with strong cultural and historical links, except for the fact that Austria does not share a communist history as a Soviet satellite like the other four do. As a result, there are important similarities in consumption habits and needs, in views about the role of money, and in the ultimate behavior of bank clients in relation to banks. Figure 2 depicts the vast difference between the fee levels in Austria and those of other countries in the sample. It indicates the dominant size of the Austrian banks relative to their counterparts from the other countries in the dataset.

Our data come from three sources. The unique bank-specific data on the fee levels have been provided by Scott and Rose, s.r.o., a market research firm with long-term

experience analyzing the Central European banking industry. The data on other bank-specific variables come from the Bankscope database, while the data on the country-specific macroeconomic variables are from European Central Bank (ECB) statistics. The data cover five Central European countries (Austria, the Czech Republic, Hungary, Poland, and Slovakia) over the period 2005 to 2006.

The empirical model

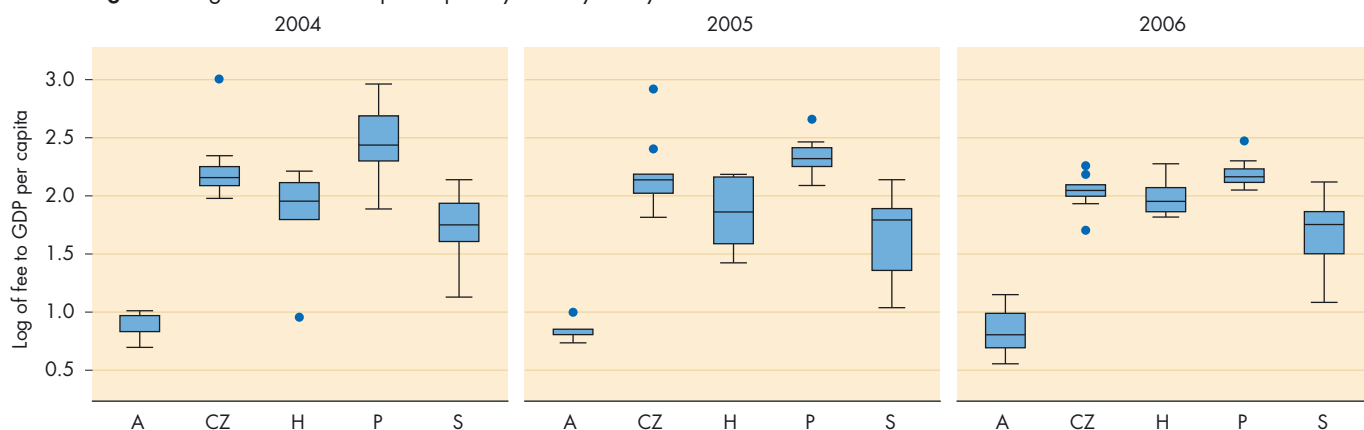
Conceptually, we base our model mainly on the set-ups of Hannan (2006) and Brewer and Jackson (2006). However, we introduce some modifications: We use an index of fees instead of individual fees and the actual distribution of services purchased by a representative bank client instead of imposing equal weights.

The use of a fee index has several important advantages compared to the use of individual fees: it is robust to differences in the

banks' strategies for pricing their portfolios of services. Within the category of core, day-to-day services at least four broad pricing approaches exist (account-based, packaged-based, transaction-based, and indirect revenue-based), which differ in how banks generate revenues from comparable portfolios of services. Two banks may charge a completely different price for a given service, while the total price of a specified set of services may be exactly equal due to cross-subsidization within the banks' portfolios. Thus, a well-specified index of the total price of a typically consumed bundle of services can clearly convey better information about the international differences in the costs of basic retail bank services than any of the individual fees.

The general framework used to build our empirical model consists of four main factors: (1) the cost of providing fee-related services; (2) competition; (3) regulation; and (4) demand-side (client-related) factors. The cost of providing fee-related services

Figure 2: Log of fees to GDP per capita by country and year



influences the fee level even under marginal cost pricing – i.e., under perfect competition. Competition and regulation determine the deviation of fees from marginal costs even in a single product environment. Finally, client-related factors account for the deviation from marginal cost pricing due to banks offering multiple products (the basic services represent only a sub-set of these products).

Results and conclusions

Generally, our research shows that the retail bank fees are negatively correlated with the economic performance of a given country. Moreover, an analysis of the factors that determine those fees reveals that when the economy grows, the fees tend to decline.

The results of our research support the predictions of the Structure-Conduct-

Performance hypothesis – i.e., that there is a positive relationship between industry concentration and prices. The results also confirm our hypothesis that the degree of reliance on cashless payments and differences in labor intensity and technological level of the banks' operations are significant cost factors that determine fee levels.

Based on the results of our analysis, it can be expected that in the future, fee levels will converge in line with the convergence of economic fundamentals. Specifically, we can expect this to happen due to the convergence in the degree of competition through the continuing elimination of barriers to international competition between banks (for example, some of the countries in our dataset are expected to enter the Euro-zone soon); in the degree of reliance on cashless payments (with the increasing buying power of consumers) and in the

degree of labor intensity and the technological level of the banks' operations (with the continuing proliferation of more advanced technologies and with the converging cost of labor).

The crucial message of our research is that the international differences in the levels of fees can be explained by fundamental economic factors. Our results oppose simplified explanations of the fee differences based on the banking market behaving as a pure cartel. Thus, the analysis in this paper also contributes to the continuing public debate about the implications of the prevailing fee levels for competition policy and the approach of regulatory institutions to banks. ■

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