

# Effects of consumer switching costs



The assumption about switching cost is rather natural to the extent that borrowers' satisfaction or dissatisfaction about a bank can be different according to individual preference to banks' services and borrowers can measure them exactly only after having the relationship. Switching costs may capture direct cost of closing an account with one bank and opening it elsewhere, the cost associated with other application procedures with other banks but also loss of relationship benefit between borrower and his former bank.

A borrower faces switching costs in a relationship with an individual bank; it would be costly to borrow from a single lender if its primary bank is in financial distress. This implies that default risk would be more sensitive to our bank health measures if the bank-firm relationship is close.

Overall, the following are the main conclusions for this study, each of these shall be discussed throughout the chapter:

The respondents elaborated that the manner in which they were affected by the crisis when the international banking system collapsed leading to drying up of credit. Living in the credit-driven environment, both individuals as well as the corporate sector found it difficult to face the “no credit” situation. Government-driven rescue packages were being announced across the world to save their respective economies. The amounts were running into hundreds of billions of their home currencies. The magnitude was so huge and the event so wide spread, that it spread across various sectors and various economies.

Image is indirectly related to the bank loyalty as perceived by quality. This is based on the results of large scale empirical results in a global level. Service quality is indirectly and directly related to bank loyalty in terms of satisfaction. Satisfaction has a direct effect on loyalty for the bank. It is now clear on level of the mentioned constructs that reliability or the quality dimension and the position in the market or the image dimension are both important drivers of bank retail loyalty.

Therefore the quality of a bank should be more important for credit line customers than for other loan customers. We therefore apply and test the hypothesis that credit line borrowers are willing to pay extra for borrowing from a bank of high quality.

A wide range of factors maintain the market power in banking. Entry into the banking sector is restricted by regulatory agencies, creating one of the preconditions for a degree of monopoly power and administrated pricing. Market power and an inelastic demand for retail bank products may also result from the existence of switching costs and asymmetric information costs. Switching costs may arise when bank customers consider switching from one bank to another, for example when a household intend to transfer its savings deposits from bank A to bank B. Costs of acquiring information and search and administrative costs are potentially important in markets where significant information or transaction costs exist.

The costs are also expected to be high in markets with long-term relationships and repeated transactions (Sharpe, 1997). Generally the existence of switching costs results in market segmentation and reduces the

demand elasticity (Klemperer, 1987). Moreover, even in the presence of small switching costs, the theory predicts that the smaller the proportion of customers that are ‘new’ to the market, the less competitive prices will be. Thus, even with non-co-operative behaviour, switching costs result in a retail bank interest rate adjustment of less than one to a change in the market interest rate (Lowe and Rohling, 1992).

Two main limitations are associated with this case study. First, we have not collected the financial performance data and therefore are not able to discuss cost effectiveness and profitability of the schemes. The second limitation is related to the drivers of customer loyalty in retail banking industry. Future investigations should focus on loyalty program component analysis, customer loyalty measures, customer attraction and profitability, and design and costs of loyalty programs.

The findings suggest that the majority of the analyzed loyalty programs reward a repeat purchasing. The retail banks automatically record individual customer’s details and transactions that provide an opportunity for marketing people to organize segmentation and targeting, and create relationship marketing strategy as well as individual marketing offers to the clients. However, the research shows that the banks are basically concentrated on two customer segments – the potentially profitable customers and the customers, who are willing to keep money in their bank accounts. Most of the retail bank loyalty programs offer their customers only a discount on the transaction costs. It could be viewed as an indirect price cut policy, which leads to the constant battle for the price.

The critical issue for the most programs launched by the banks is to reinforce the value proposition of the bank brand, to enhance loyalty toward the brand, not just toward the rewards. Relationship marketing strategy and relationship based loyalty programs are important to retail banking service providers, because it is a right way to build relationship and loyalty.

Furthermore, a conclusion is reached that retail banks are offering non-customized loyalty programs and that marketing specialists are not familiar enough with the factors that determine the choice of loyalty programs.

Based on the results, loan securitization can be utilized as a strategic tool to soften the competition in the loan market. Like all financially troubled firms, a bank's debt pricing strategy is likely to be driven by the need to generate cash to boost liquidity to fund investments or to raise short term profitability. The deposit pricing strategy chosen however may not be uniform and instead will depend on institutional factors and also segmentation between different classes of deposit investors.

The most important institutional factor affecting pricing strategy of distressed banks is deposit insurance; the existence of fixed premium deposit insurance alters the nature of the more general creditor-owner conflict. For any distressed firm the incentive to generate funds to boost short-term profits or to gamble for survival exists; these funds in theory can be obtained directly through the financial markets. For most firms debt covenants make gambling difficult but for banks financing through depositors may be readily available to the extent deposit insurance exists. Because deposit insurance eliminates the incentive for depositors to monitor

bank risk, it makes generating large amounts of funding, to use in risky investments, much easier. This seems to be, to a large extent what happened to financially distressed banks in U. K. during the time period studied.

But the fact that all dimensions of bank deposit rates do not increase with distress and the fact that some increase more than others suggests that deposit insurance does not seem to be the only factor affecting bank deposit pricing strategy. Differences between classes of depositors allow banks to tailor deposit pricing strategies to best obtain funding in the most cost-effective way. Distressed banks tend to increase deposit rates only for the most investment oriented depositors (non-transaction account depositors) and do not significantly raise rates for the least investment oriented depositors (transaction account depositors). Additionally, not fully insured investment oriented (large time) depositors tend to be offered rates higher than mostly insured investment oriented (non-transaction non-large time) depositors. Thus distressed banks offer a premium both based on the increased risk (if deposits are uninsured) and for depositors being more investment oriented. Past works have generally suggested that troubled banks bid up deposit rates in a gamble for survival or that they may have to offer higher rates for uninsured depositors to compensate for the increased risk. The results suggest, that both explanations are partially correct in that they are both factors to varying degrees based on depositor class and that neither are significant factors for the least investment oriented depositors. The results provide fresh evidence that moral hazard is a issue in banking and moreover that it is increased by deposit insurance since distressed

banks apparently raise rates less for investment oriented investors who have a larger portion of their deposits insured (non-large time non-transaction depositors) relative to more uninsured investment oriented investors (large time account depositors). The fact that deposit rates do not increase for transaction account holders as distress increases while other types of deposit rates increases is also important to consider; it suggest that moral hazard in conjunction with the convenience orientation of these depositors allows distressed banks to maintain this funding source at minimal cost regardless of risk. Thus the evidence suggests that both deposit insurance and the convenience orientation of a certain class of deposit investors imposes costs on the final creditor (the FDIC in this case) when a bank is in financial distress. Thus the results have important implications for regulators.

The researcher documents the presence of positive duration dependence in relationships. In other words, firms become more likely to end a bank relationship as a relationship matures. Taken alone, this result suggests that the value of relationships decline through time, and those firms are able to end relationships early, possibly to avoid lock-in. This inference is strengthened by the fact that small, young, and highly-leveraged firms maintain the shortest relationships. Although theory suggests that such bank-dependent firms are the most susceptible to lock-in, our findings imply that switching costs are low enough to permit these firms to change banks often.

Holding other firm characteristics constant, we show that competing bank relationships reduce the market power of any one bank, making long-term relationships more valuable. Although firms with multiple bank relationships

terminate relationships frequently, they do so by terminating newer relationships and keeping long-term ones. Intuitively, the existence of alternative sources of bank credit reduces the ability for any one bank to threaten holdup. With lower holdup costs, a long-term relationship becomes more valuable to the multiple-bank firms.

The researcher also finds some indication that firms terminate relationships as they outgrow their banks. Firms tend to switch from small banks to larger banks, and maintain the longest relationships with Norway's two largest banks. However, we find no evidence that this preference for larger banks arises as a result of limited capacity at other banks. Instead, growing firms could prefer the higher quality services offered by the large banks.

The evidence presented here should be useful to future theorists interested in modeling the value of bank relationships. However, one should take caution in drawing far-reaching conclusions from this study. Our data reveals very little about the actual nature of the relationships. We are unable to observe how the price and quantity of lending change over the course of the relationship and do not know the other types of banking services offered to customers in a bank relationship. Indeed, an ideal extension of this study would be to obtain a time-series of relationship-specific information about banks and their customers and examine the duration of the relationship as a function of relationship-specific variables.

The constant effort of managers to stimulate customer loyalty involves customer integration in the firm value chain as a result of personalised marketing (Vesänen, 2007) aiming at intensifying the relationship between



the supplier and its customers and increasing customer loyalty. Customer loyalty can be seen as a result of switching costs, opportunity costs and sunk costs based on technological, contractual and psychological obligations faced by a customer (Jackson, 1985; Riemer and Tetz, 2003). All sources of these costs are based on the interaction with a customer during the course of integration. Switching costs increase due to the established trust towards the supplier and its capability to meet promised quality levels. If customers can be persuaded to invest significantly in a specific relationship, then sunk costs increase. Additionally, if customer satisfaction is positively influenced by customisation, then a customer's opportunity costs increase as a defecting customer risks losing the net benefits of the current relationship (Riemer and Tetz, 2003). However, not all companies will be able to draw profits from these saving potentials to a similar extent, regardless of whether they have already realised the existence of these effects.

The degree of customer interaction is influenced by the characteristics of the good being individualised, such as its complexity, the expenditures and the risks of its utilisation and customisation.

The paper contributes to the literature in identify new strength and weakness areas concerning the actual range of services offered by retail banks, the re-purchase intentions, the state of relationships with customers, and the competitors' image positioning.

The findings of this research suggest several implications also for marketing practitioners, as they validate the concept that relationship marketing orientation is critical for business performance. Firstly, since only when the

satisfaction with the core service and relationship is high, the commitment will be higher, banks have to ensure that utmost importance is given to attributes like quality, product features, product availability etc. Moreover, the staff role is critical in understanding the customer needs and in satisfying them: the higher satisfaction will then increase customer retention.

Secondly, relational switching costs can be increased only by investing in the soft or the relational assets (Nielson, 1996), in terms of various adaptations to favour the customer and also the investments in other soft assets like training for the working staff of the customers etc. Since the interaction is mostly interpersonal in nature, these outcomes hold major lessons for them.

Finally, the moderating effect establishes that the investment in the relationship with the customer will raise the relational switching costs. This will help in customer retention, as the customer will not terminate the relationships even if the satisfaction is lower. It makes the entry of any other competitor difficult as he has had no investments in relationship so far.

The findings of this study highlighted the strong role of social network in influencing consumer behaviour. Therefore, customers are more willing to participate and interact in the creation of the offer, since they feel a sense of belonging. Practitioners should encourage social network in order to minimise the switching behaviour (see for example the credit cards industry), upgrading their relationship perspective from customer relationship management to vendor relationship management (Berkman Center for Internet and Society). Minimisation of switching behaviour will

lead to better customer retention, which will eventually lead to better bottom lines.

Certainly, the analysis has some limitations, such as the sample size, the variables and the area considered; future research will be focused especially on the multiplicative variable, which was eliminated from the model probably due to the variables considered, in order to assess the joint effect of the three macro variables on customer loyalty.

The results are consistent with the hypothesis that bank lending is characterized by borrower capture – perhaps due to informational monopolies and other sources of switching costs -, as the firms that suffer most from increased market concentration are those that have no alternative lending sources. The efficiency gains of increased concentration are shared only with firms that hold loans from multiple banks.

These informational switching costs become particularly relevant during episodes of rising market share. For instance, a firm that has established relationships with two banks that ex-post merge, loses its ability to limit lenders' power through switching its funding source. Rising concentration and mergers thus produce borrower capture. Moreover, relationships are built through repeated contact between the client and particular bank officers. If these matches are broken over a merger, then valuable information on client's risk may be lost.

The results point out to the fact that having alternative lending sources isolates firms from the adverse effects that rising concentration and mergers may convey. Thus our findings are consistent with the existence of

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informational monopolies and switching costs. Moreover, the efficiency gains that result from larger market shares are passed on only to clients that face lower switching costs.

Switching costs are much lower if the firm holds loans from more banks, and can threaten to move its business elsewhere if a lender charges higher interest rates. Alternatively, a firm that holds loans from multiple banks is more likely to face rate reductions when its lending source becomes larger and gains efficiency.

Little is known about what governs recovery from banking crises. The first pass at these data uncover several robust patterns. Banks that are already in trouble tend to lend money to riskier clients. Another important factor for recovery is the size of the initial drop in profit during the onset of the distress. Third, it also matters the general climate of the bank after the financial shock. But no evidence was found that there was anything different about the banks that recovered from the downturn when many banks were distressed than during other periods. Fourth, recovery also depends the factors that the bank can control. Loan level data suggests that an important reason why the recovering banks manage defaults better is that they are tougher on extending credit to their riskiest customers.

Regulators tend to disclose relatively little about what steps are taken with respect to banks that require intervention. Our findings suggest paying close attention to whether the distressed banks are being particularly vigilant in containing credit to high risk borrowers. To the extent they are not doing so, the regulators could push in this direction. For countries that have credit

registers and credit ratings that are readily available this would be easy to implement. Likewise, where regulatory assessments concentrate on a CAMELS which means capitals, assets, management, earnings, liquidity and sensitivity to risk of the markets rating system, the supervisors might want to pay particular attention to the riskiest assets and customers.

SME markets have a dimension that is local. This comes with entry barriers and switching costs and there is a room in exercising market power. In banking business both satisfaction and switching costs can be regarded as loyalty antecedents; however, satisfaction influence on loyalty is greater than the influence of switching costs. Researchers established a relationship between overall satisfaction and customer intentions to recommend a bank and to remain a customer. Despite the fact that financial products still are not differentiated, the customers in banking sector cannot make objective assessments of service quality, that is why the concept of trust is very important here.

Switching costs inhibit a return to the local currency even after a successful stabilization effort. These well know incentive effects give rise to the conjecture that once de facto dollarization has reached a threshold, it may well persist, leading to the observation of dollarization hysteresis. Each of the foregoing indices depends upon a number of economic variables that reflect the relative incentives to hold the different assets described in both the denominator and numerator of each index. These incentives include relative rates of return as reflected by interest rate differentials, inflation differentials and exchange rate depreciation as well as the relative costs and

benefits associated with network externalities, switching costs and risks of banking institutions.

An empirical model was proposed for the strategic behavior of firms in the presence of switching costs. The models used the transition probabilities that are in strategic interaction of firms in order to derive equations that can be estimated. The proposed model's novelty is its ability in extracting information for both the significance and magnitude of the switching cost. It can also extract information on the transition probabilities of the customers. In order to illustrate the model was utilized to a panel of banks in order to estimate the switching costs of bank loans in the market. We have found that the grand average point estimate of switching costs is about 4.1%, and may be as low as 0.2% when only banks with the largest loan portfolio are included in the definition of the market. When the market is defined according to the branch-network size the switching cost among the largest banks is about 2.1%. 23% of the customer's added value is due to the phenomenon of lock in that is generated by the switching costs. As much as 35.0% of the bank's market share is because of the bank-borrower relationship that is already established. The model estimates imply an average duration of bank-customer relationship of 13.5 years. All the above characteristics exhibit lower values for the group of larger banks whose loan portfolio is dominated by more mobile wholesale customers.

To summarize, market bank loans' switching costs are quite substantial and constitute a significant portion of the value of a marginal customer to the average firm. The presented technique may be applied to other markets in order to gain insight into the empirical regularity of switching costs.

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The major contribution from this study is that switching barriers affect significantly the level of customer retention, and also affect the relationship between customer satisfaction and customer retention. It does seem that switching costs could be used to predict consumers' behaviour in the banking sector. Customer satisfaction has positive effects on the customer retention. Thus, manager may need to emphasize total satisfaction programme in an attempt to retain customers in the competitive banking market.

However, the moderating role of switching barriers in the relationship between customer satisfaction and retention is indicative that for low involvement services as credit services switching barriers may play a big role in customers retention programme. Managers therefore, must significantly consider switching barriers and dimensions of customer satisfaction when making plans or focusing efforts in customer retention. The study attempts to differentiate the consequences of consumers' behaviour in terms of exit and loyalty. However, the effect of switching barriers on consequence is significant only when customers consider to exit. One major area of future research is the role of government policy in creation and removal of switching barriers especially in a developing economy where government participation is crucial.

Besides the switching cost, customer lock-in is essentially driven by relationship lender's informational advantage compared to outsider lenders. The researcher shows that higher switching cost, which can be thought to reflect greater concentration in local credit markets, does not necessarily lead to higher equilibrium profits in relationship lending. Adverse selection

problem curtails price competition when the switching cost is low by discouraging outsider banks to make too aggressive bids. Threat of adverse selection gradually fades away as the insider's bank profits are reduced and the cost of switching bank's increase.

On the other hand, lack of competition starts to dominate for sufficiently high levels of switching cost, so that insider bank's profits become increasing in this cost.

The researcher's finding runs counter to the Petersen-Rajan (1995) argument that competition is generally detrimental to relationship lending. The V-shaped pattern, however, is supported by recent empirical evidence in Elsas (2005) and, to some extent, in Kim et al. (2004). A clear tendency for a V-shaped relationship between availability of institutional debt and relationship lender's market power also arises in the empirical part of Petersen and Rajan's (1995) own study. This is the case especially in the category of firms older than five years. The reason why the similar tendency does not emerge in start-up financing is probably because insider lender's informational advantage is not very pronounced in that category. If the model is solved assuming sufficiently inaccurate private information by the insider lender infinitesimal switching cost (= intense competition) is shown to lead to low profits and no clear-cut V-shaped relationship arises.

The researcher also finds that allocation of financial resources is most efficient under intermediate market structures: low switching cost tends to augment adverse selection problem, while some of the 'good' loan applicants are left without finance when the cost of switching banks is



sufficiently high. However, if insider banks can invest in the accuracy of private information, the incentive to acquire information is stronger when the expected benefits from relationship lending are higher. Therefore more efficient information acquisition can potentially counterbalance the inefficiencies in resource allocation when the switching cost is either very low or high.

According to our results, learning costs best explain perceived average costs, followed by continuity costs. Lost costs do not significantly explain perceived average costs. This regression tells us that to obtain a strong perceived average cost, one variable with a significant impact is learning costs.

However, this variable is more difficult to manipulate. In addition, increasing learning costs may create induced loyalty, which would be perceived poorly. Clearly, making a financial institution's processes more complicated just to create barriers to leaving would not be a very good strategy.

Continuity costs are a variable that financial institutions could control in order to achieve "desired" loyalty. For example, loyalty programs would grant customers special privileges. Customers would be less likely to leave, for fear of losing these benefits. Non-monetary privileges such as the increased availability of a financial advisor or simply the fact that an advisor knows a customer's name can increase the switching costs perceived by customers.

Banks can make substantial profits in some people's eyes; they must also demonstrate transparency in their communications and position themselves as being in touch with their customers. They should not come across as cold

businesses that are only care for people with money. They should welcome customers warmly and treat each one fairly, especially if they want to appeal to a younger population (18-30 years old). Younger customers should be treated in the same way and just as seriously as older customers.

Switching costs have a minimal impact on loyalty even though, as we have observed, there is clearly a connection between perceived switching costs and loyalty. Nonetheless this variable is not a requirement in a loyalty strategy for young people.

In summary, a loyalty program with special benefits for young people could be an effective part of a loyalty strategy, but financial institutions must first ensure that customers trust them and are satisfied with their products and services.

This study also highlights the essential role of main bank power, measured by equity holdings, in enabling firms to change “inside” banks. Apparently, switching to a new bank which holds equity of the firm reduces the switching costs. In addition, the researcher finds no evidence that main bank power has a material effect on firm performance, but it does affect the loan ratio by increasing the amount of credit with a term of one year or more.

Banks with a high level of nonperforming loans are compelled to curtail lending due to their impaired financial health. In contrast, less capitalized banks are associated with higher loan ratio of their clients. Thus, the findings provide more fodder for the debate over the potential for banks to structure clients' balance sheets. It is worth noting that whether and in what amount loans will be made is crucially dependent on the bank's characteristics (i. e., <https://assignbuster.com/effects-of-consumer-switching-costs/>

how much money does it have to lend), whereas interest rates (measured by interest payments) are determined by the borrower's creditworthiness.

A core finding of this research is that firms perform worse after switching, which is in accordance with Degryse and Ongena (2001). Apparently, the firms that switch banks are seen as risky and, therefore, the new bank charges higher interest on the credit it grants. This is reasonable behavior on the part of banks as von Thadden (2004) argues that particularly low-quality firms are more likely to switch banks. It would be very interesting to discover how permanent this poorer performance is and to what extent bank health affects loan conditions.

The issue of strong bank power implying high switching costs for firms is of great relevance to policymakers in that financial institutions tend to choose insufficient structures in the absence of sufficient competition and this situation can result in wealth redistribution in developing countries (Rajan, 2002). To guard against banks having excessive power, many developed countries set limits on the amount of equity a bank can hold in a single firm (Morck et al., 2000). This type of regulation is rare in emerging markets so far, making non-financial corporations quite susceptible to shocks generated in financial sector.

Perhaps the most interesting empirical regularity uncovered in this study is that banking crises are not accompanied by substantial declines in bank deposits relative to GDP. Thus, while depositor runs have played a central role in the theoretical literature on banking crises, in practice they seem to be a sideshow at best. A possible explanation is that generous bank safety

nets are present, and depositors have little to lose despite widespread insolvency in the banking system. However, our bank-level analysis indicates that deposits do decline in weaker, less profitable banks, suggesting that depositors are actively and accurately monitoring financial institutions. If funds withdrawn are re-deposited in healthier banks, then the stability of aggregate deposits can be reconciled with the evidence of runs on weaker banks. This is an issue that deserves further study. For instance, if indeed large scale reallocations of deposits occur following banking crises, how is the functioning of the financial system affected? Can the payment system, the interbank market, and the supply of credit continue to work smoothly?

Bank financial distress, be it the result of illiquidity or insolvency, may help propagating adverse shocks to the real economy if it forces banks to curtail lending to creditworthy borrowers. Banking crises do not seem to be followed by prolonged recessions: the slowdown in output growth is usually sharp but short-lived, with growth rates back to their pre-crisis levels in the second year after the crisis even though credit growth remains depressed. An open question for future research is how do firms finance the recovery in the immediate aftermath of a banking crisis, and at what stage – if any — does the lack of bank credit become a hindrance to growth.

The analysis of bank level data indicates that even healthier b