ANNEX A

BDRC focus group research

SME Business Banking

Qualitative Findings

29th November 2013

bdrc continental

providing *intelligence*

Contents

Overview of method, locations and audiences

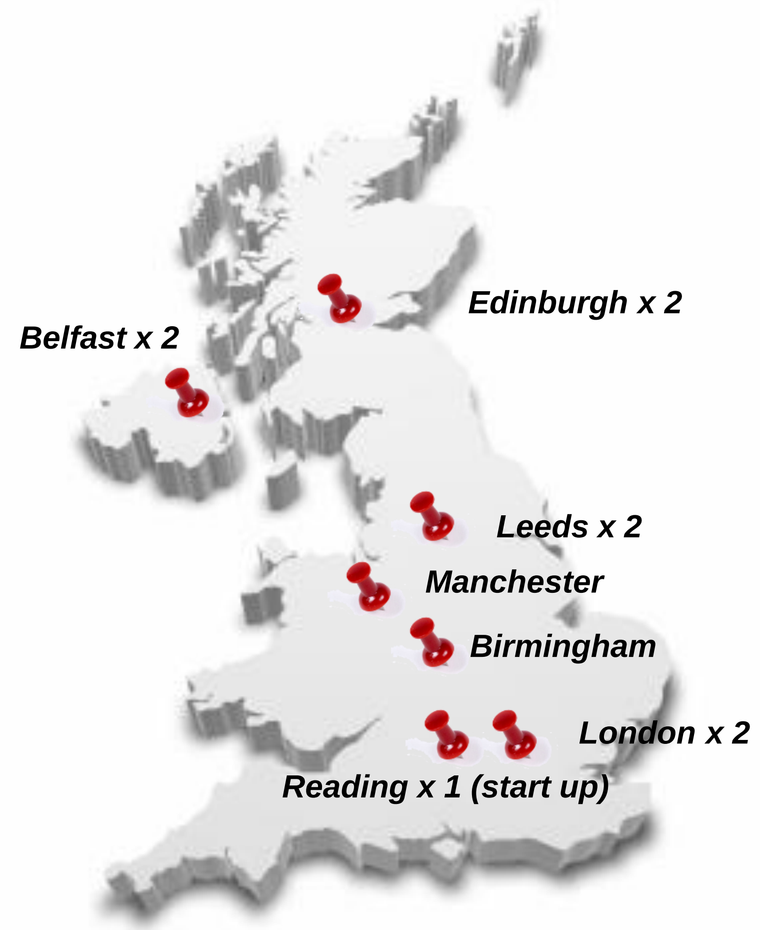
11 Task Based Focus Groups

- **90 minutes**
- **8 respondents in each group**

Screening process to ensure mix of SMEs by size, sector, age, type of respondent (e.g. owners and senior financial decision makers) and region

NB: SMEs with existing borrowing were included, but it was decided to exclude those struggling with their repayments and with the general solvency of the business

NB: SME Finance monitor figures show 18% of SMEs use PCAs and we did not *exclude* people on this basis - however we didn't come across examples of this behaviour



Fieldwork conducted between 18th November and 5th December 2013

Participant selection was based on the **needs** and **wants** of the SME from their bank

From other work amongst this audience, BDRC Continental suggested recruiting SME decision makers across two dimensions: **need for services**, based on the complexity of the business and **desire for a relationship** with the bank and the relationship manager

	Transactors Cost more important than relationship. Likely to do most banking via direct channels	Relationship Seekers Relationship more important than cost. Likely to have regular contact with people at the bank
Complex Bigger, more employees/higher turnover. Greater banking needs: lending, letters of credit, invoice financing etc.	Lots going on, but broadly happy to self service / more likely to multi-source	Looking for a genuine partner in their business bank
Less Complex Smaller with fewer banking needs	Low level needs: Internet banking / telephone banking	Looking for a relationship – even if this is only 'Elsie' in the branch

Verbatim comments are labelled to indicate whether the respondent was from a complex or less complex business or (attitudinally) a transactor or relationship seeker.

Note on methodology and terminology

This report provides findings from **qualitative research** (task based focus groups) conducted amongst owners and senior managers of SMEs, commissioned by the OFT in November 2013.

The purpose of qualitative research is to **discover** the full range of views on a topic or issue, looking to **understand how and why** these views are expressed by respondents.

It is **not** the role of qualitative research to **measure** – e.g. the *proportion* of small businesses of a certain size that believe A versus B with regard to the competitive nature of business banking. This could only be achieved via quantitative methods involving much larger sample sizes.

Additionally, in order to fully explore the needs of larger, more complex SMEs, **recruitment was skewed** to include a larger proportion of these businesses than exist in the overall population of SMEs in the UK (see slide 7 for details)

For these reasons, **it would <u>not</u> be good practice to count** (in any single group or across groups) the number of respondents stating a particular preference or suggesting a particular point of view.

- For example, were we to state that 66 of 88 respondents suggested X, the reader might reasonably (but quite falsely) assume that 75% of the overall SME population believed X

So **how should the terminology be read?**

Where we use the word, ***some***, this is **indicative** of a view held by more than just one or two SMEs across the audience indicated (e.g. complex SMEs)

Where we use the word, ***many***, this is indicative of a view held by a significant proportion, but not necessarily a majority view

Where we use the word, ***most***, this is indicative of a view held by the majority of those spoken with.

Market Context

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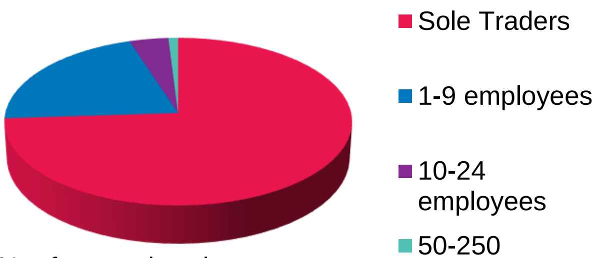
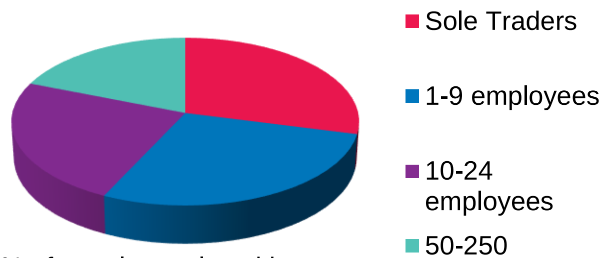
SMEs are not a homogenous group

Sole traders dominate by proportion of businesses…



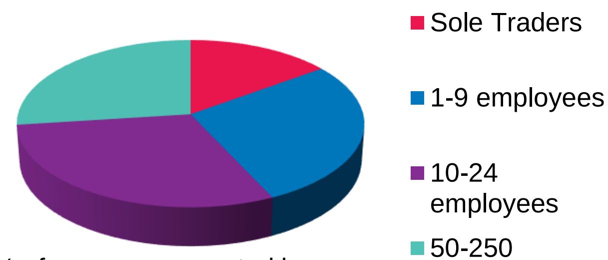
% of enterprises by business size (employees)

…but by number of people employed the split is more even



% of people employed by business size (employees)

…and most of the revenue is generated by larger, more complex SMEs



% of revenue generated by business size (employees)

Source: UK National Statistics BIS Enterprise Directorate Analytical Unit 2009

Whilst it was important to include the views of sole traders in this research, it was also critical to explore the views of larger, more complex SMEs with employees

Many of our findings focus on the different needs, experiences and views of those across the spectrum. In reading these findings, it's important to have these graphics in mind with regard to the nature of the overall population.

- i.e. by proportion of SMEs, most are sole traders with quite basic business banking needs

Latest SME monitor results show that 41% of SMEs use external finance, 40% meet the definition of a Permanent Non Borrower and 1 in 5 of all SMEs are PNBs with no plans to grow

SME customers only aware of the major players

Focus group participants perceive the market to be dominated by the bigger banks

- These are the names most SMEs have heard of
- These are the ones holding the bulk of personal accounts – a logical first step for new businesses looking to open an account
- They don't feel like they're going to go away – *maybe if there had been more big 'brand casualties' in 2008 this would be less true*
- Building societies generally felt to be not much interested in business banking
  - Plus recent negative press around mutuals – Co-op and others

There are new players coming up on the rails:

- **Metro** (one start-up used this – got a free sandwich toaster!) – but still seen as a bit quirky (and even this customer went there only after being let down by her PCA bank)
  - Limited distribution not an issue if you're a small local business and planning to stay that way – different if you're planning to expand, have multiple sites.
- **Handelsbanken** – no awareness amongst the SME's we spoke with

SME customers only aware of the major players

"If you're doing international trade, obviously with the credit, the chances are a bank like HSBC is going to have more relationships with overseas banks than a provincial bank" (London Complex RS)

"I think the choices are kind of limited and it's the big banks: Royal Bank, HSBC." (Edinburgh Complex)

"Why are people surprised about the stuff about the Co-op Bank? Why are we still surprised when you see a scandal involving a bank four years or five years after 2008?" (Belfast Less Complex)

Northern Ireland has different market players and different customer preferences

Ulster Bank (RBSG) First Trust (AIB), Northern Bank, Bank of Ireland are the main players

Views were expressed that these had been operating virtually as a ‘cartel’* – certainly until the takeover of Northern Bank by Danske Bank – perceived to have ‘refreshed’ the market somewhat

*exacerbated by historical sectarian divisions which meant that people / families tended to stay with the same banks for generations – this appears to be breaking down over time according to respondents

Northern Ireland has different market players and different customer preferences

"Your choice of banks was where your dad banked and where your Grandad banked. It wasn't really based on commercial competitiveness, certainly for my generation."(Belfast Complex)

*"The four big banks here in Northern Ireland had a cushy ride for years and they all had their big lunches and dinners and decided what they were going to do for the next ten years and we all just had to buck up and lump it. I think mixing it up with a Danish bank (Danske) has the other three going, 'Oh s**t' "* (Belfast Less Complex)

*"Danske didn't overextend themselves so much by over-lending that they're not in the s**t that all the other banks are in and so they can continue to be reasonably sensible."*(Belfast Less Complex)

"There is very little opportunity to move banks if you're in the Northern Ireland context, unless you maybe go to one of the new entrants and take your chance there." (Belfast Complex)

"Ulster Bank, and I feel it as a customer, the IT shutdown, you can just feel that that bank is built on sand foundations at the moment and you feel that there could be an impact on you as a consequence of that." (Belfast Complex)

Some overall observations…

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What do SMEs use banking for and what's important to them?

Transactional – Online (direct) and branch

- Increased use of direct channels – some sectors less dependent on branch
- Almost all use online banking, and being able to do this simply and easily is pivotal to their experience of business banking
- There is a group for whom branch is also an important element, particularly around cash handling

Relationship (manager)

- For many this is simply the people they talk to at the branch
- Some have a named contact or team – but it's not a relationship
- A few have a genuine 'bank manager' – but this is a trouble-shooter / conduit into the organisation

Lending / international / other

- Only the larger or more complex SMEs use these services
- 16% of SMEs have an overdraft, 14% are international*

*SME Finance Monitor

What do SMEs use banking for and what's important to them?

"It's a good working relationship, when my company was having problems he knew me, he's known my history, financially he helped me in certain situations" (Birmingham Complex)

"I can't remember the last time I went into the bank. Most of it's done online and all our invoices when we expect payments in the customers pay electronically as well." (Birmingham Complex)

"*We haven't got a relationship manager, but it hasn't bothered us, we haven't had any problems at all. We do mainly internet banking, and if we have a problem we do speak to somebody, it's not a call centre, and everything's always been dealt with very professionally, so I was quite happy with everything.*" (Leeds Less Complex)

"Well, I have tenants paying, because I do a lot of property management, and not only do they pay cheques, but sometimes they pay cash" (Leeds Less Complex)

"Today with credit cards, highly automated cash points, we can do at the bank, check the receipts and things like that, online banking" (London Complex RS)

Supply and Demand

The perfect competitive market for SME banking might feature:

- Lots of suppliers keen to attract new customers
- Lots of customers keen to find the best deal

But with SME Banking, it's just **not like that** – and competitive drivers rarely come into play until the SME becomes bigger, more complex and more profitable…..

Small SME, simple banking needs

Low salience (for the SME and the bank)

If complexity increases over time, so (potentially) does interest in banking / from banks

Relationship seekers, international / borrowing

Banking becomes worth reviewing – and worth the bank's attention

For many, banking remains a simple, transactional matter, low cost and of low interest

Still low salience

Business banking has low salience: SMEs want to focus on 'doing their thing'

In smaller, less complex SMEs, the people involved have a very broad range of financial sophistication:

- Taxi drivers, florists, builders etc. - know their trade, but are sometimes overwhelmed by the demands of being a sole trader – HMRC, VAT, Health and Safety etc. - why worry about business banking if they don't need to?
  - Life's complicated enough
- On the whole, needs are **basic** – transactional / day to day
  - And at this level, it's hard to differentiate by bank (all do / offer similar)
- For many of these, **the cost of business banking is low** (£15 or so a month for many in the start-up group) – saving a few pounds off of this is a **low priority**
- *From other work*, we know that there are* ***are*** *businesses at this level who struggle to get out of the cycle of late payments – bank charges / returned cheques etc. And it may be these businesses who feel more 'trapped' within relationships – but this is a relatively small sub-segment*

Some large, more complex SMEs either develop financial sophistication or buy it in (Accountant or FD)

- Spending more on business banking and on a wider range of services (LCs, Invoice Financing etc.) and having the financial expertise in house, means that they have both the motivation and the skill set to consider alternatives
- This enables many of these larger businesses to source services and negotiate with banks on the basis of the overall value of the account

*SME Finance Monitor

Business banking has low salience: SMEs want to focus on ‘doing their thing’

*I've just put 'finding a secure place to keep my business funds, end of story'. I wouldn't spend a lot of time on it. (*Edinburgh Less Complex)

*“It (my business) consumes so much of my life that when I walk out of my office or my studio I don't really want to think about it anymore” (*Birmingham Complex)

“For a small business time is money isn't it? My time is more valuable and trying to sort out problems is going to cost you money anyway.” (London Less Complex RS)

The balance of power between the bank and the SME

Prix Fixe

You 'get what you're given'
You have little or no negotiating power
You may have freedom to switch, but it doesn't necessarily feel that way

Size and complexity of business

OR…..

Prison food

The bank can 'turn the lights off'
You don't want to offend the bank
You don't feel you can switch – few options available

A la carte

The bank wants your business – and you know it
You can negotiate
You can switch – or threaten to switch

The balance of power between the bank and the SME

"As a start-up business there's limited choice, it's more who'll take your business. It's who will have you. That's the reality. I got to the point where I was like, 'Jesus, I might not get a bank'."
(Belfast Complex)

*"We like to get banks in and actually get in to try and sell, tell us why we should choose them. The banks are selling you a service and you've got to get them to convince you" (*Edinburgh Complex*)*

'Bank Manager said to me 'You can do all the marketing in the world you want but if you're not making a profit we'll turn your lights out."
(Belfast Complex)

You don’t worry about things you don’t know about…

“ *... there are known knowns; there are things we know that we know.*
There are known unknowns; that is to say, there are things that we now know we don't know. But there are also unknown unknowns – there are things we do not know we don't know.
(Donald Rumsfeld)

For most small businesses, there are lots of unknown unknowns:

- The level of competition between banks for their business
- (what lies beyond their own bank)
- The differences between banks in terms of cost, servicing and value

It’s not just that they ‘don’t know’ the answer to these questions, it’s more that they just **haven’t even thought about them.**

Concentrating on running their business is a full-time job, their priority

You don’t worry about things you don’t know about…

“I think you have details at the beginning when you open your account and then it seems to increase and increase in terms of the amounts. But you don't pay attention to what's going on in the other banks and whether that's actually exactly the same as other banks or not” (Birmingham Complex)

“If it ain't broke, don't fix it, you know? Why change something that is working for you?” (Edinburgh Complex)

“I actually think I went into this with my eyes shut” (choosing bank) (Edinburgh Less Complex)

“All the banks are much the same. So each bank, I think, follows a very generic template now.” (Belfast Complex)

Awareness is a key issue:

Most not aware of alternative options for business banking outside the largest five banks (RBSG, LBG, Santander, Barclays, HSBC)

- Struggle to name anyone else that offers business banking
- A handful have heard of / use Metro

SMEs assume that all will offer broadly similar services and charge broadly similar fees

There is certainly no antipathy towards new entrants / smaller banks

- With the caveat that using these would need to be convenient – ability to pay in cash / cheques
- Greater interest in these amongst the larger SMEs who see it as ‘shaking up the market’
- Also at the larger end there is greater awareness of alternative finance options / providers – asset financing / leasing etc.

METRO BANK

Lombard (cars)

Mercedes vehicle contractor

Awareness is a key issue:

*"If I needed finance for a vehicle, you'd not be getting it off your bank anymore. You get in touch with them, you fill in a form in, or you start the process, they're then putting you on to Lombard, or they're putting you onto - they're selling you to somebody else. That's what I find really, really frustrating. They are just another middle man." (*Manchester Complex)

"I think changing the norm is always a good thing (a new bank). Putting the cat amongst the pigeons in the bank, it would be a great bloody idea." London Complex RS

*"I'm glad to see Metro is coming in because anything to shake up the market is a good thing." (*Slough Less Complex Start-up)

*"Just used Lombard in years gone by just for some finance investment into the company, a better rate, not recommended by the bank" (*Leeds Less Complex Transactor)

Starting up…

For start-ups, finding the best business banking deal is not top of mind

HMRC – Tax and VAT

Registering the company

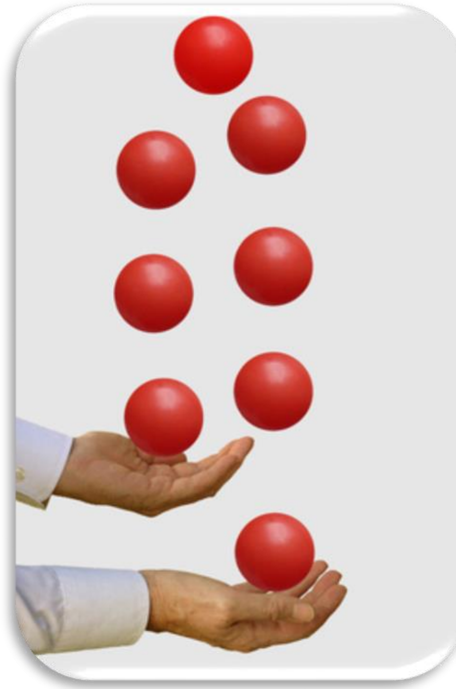
Finding premises (if needed)

Finding customers

Negotiating with suppliers

For most, finding the business bank is a quick decision / an afterthought

- Need somewhere for customers to pay into
- Need somewhere to channel funds to suppliers
- Need something that works for their accountant



There are varying degrees of insecurity when starting a new business. So some are actually quite **grateful / relieved** if their PCA bank is willing to give them a business account such emotional gratitude can cloud rational evaluation

- This 'ticks a box' and is also a degree of endorsement for their decision to go it alone

For start-ups, finding the best business banking deal is not top of mind

"When I started, if you started a business, if it's a new account, you've got so many other things to be thinking about and it's basically 'we need to sort our bank account'. within that afternoon you've generally arranged an appointment, or you have filled in an online form" (Leeds Less Complex Transactor)

"I was more involved in trying to set out the business side and get people to give me work than I was worrying about whether I'm going to spend £5 on bank charges, or £20 on bank charges." (Slough Less Complex Start-Up)

"I think actually the banking side of actually setting up our business was very unimportant, I guess a necessary evil to have somewhere we could take the money in, so effectively you've got the chore". (Slough Less Complex Start-Up)

"I opened my account 16 years ago and I was kind of grateful that they gave me an account" (Edinburgh Complex)

SME start-ups generally don't shop around because it doesn't add up (in their minds)

SME start up perceptions summarised:

I'll go to my PCA bank because…

- Simple / easy
- Feels safe / known
- If my bank won't give me a business account – who will?

+

And anyway…

- Low return on investment for the hassle involved in researching other banks
- Low perceived benefit – 'they're all about the same / doesn't cost much'
- Maybe not sure of what my needs will be

=

An approach to my PCA bank

meets my emotional and rational needs

Start-ups generally don't shop around because it doesn't add up (in their minds)

"When I decided to stay with the same bank, the credit scoring, your whole performance. So if you've got a personal account with the bank and that's been okay, and then you've got a business account with the same bank and that's okay, you know, the building up of - so, you know, it stands you in good stead going forward."
(Leeds Less Complex)

"I think you tend to stay with the bank you know that you've had. I've had the account for years, and then they just opened me up a business account because it was easier."
(Slough Less Complex Start Up)

"The fact that I'd banked with Halifax for 20 years and I knew they were part of the same kind of bank. I thought that might just ease the application process of not having to give blood at the counter to get your account, and in fairness it did work. I didn't have to provide ID and all that sort of stuff."
(Leeds Less Complex Transactor)

Some do shop around on start-up, but this is not the norm

The logical thing is to talk to a bank where you have an existing relationship (PCA)

- Know your history, easier/quicker to process application (logical)
- Assume will be more supportive of your business (emotional)

You only go outside this when:

- You want a bank that is financially independent (i.e. not propped up by taxpayer cash)
- You want to use the bank that has a branch near to where you work – convenience
- Your PCA bank makes a mess of the application process / cancels your appointment etc.
- You ask others for recommendations: accountant, other business acquaintances
- Have investment from a source who has bigger clout with a different bank

Some do shop around on start-up, but this is not the norm

*“Our accountant who put us onto it. He said, 'Just shop round'. Obviously we were still fresh in the water at the time, and you don't want to change. He said, 'Your fees are through the roof, so you need to go and do something'. (*Birmingham Complex)

“I would feel, in principle, that they would be able to access your personal records to know that you were creditworthy or otherwise.”
(Leeds Less Complex)

“Again, it's just the whole comfort factor. You actually know the kind of thing that you - well, certainly in my case there wasn't any great filling in of massive business plans required, because they kind of knew that I was a safe bet, pretty much”
*(*Edinburgh Less Complex)

Some do shop around, so what do they do?

Those who have shopped around (mostly online) are not aware of aggregator sites where they can compare between accounts

- They search on individual brands that they've heard of and try to make comparison themselves – which they admit is time consuming and difficult to identify differences between bank offers
- There is a tendency to latch on to one or two cost items (e.g. cost of cash handling) and make the decision based on this
- Combined with services required e.g. on-line banking
- Some relationship seekers choose a bank where they will be given a RM
- Some investigate security measures available e.g. HSBC fob security key (but not as big a differentiator these days)
- Very few go into more than one branch – unless they are disappointed by their first experience
- Usually assessing current banking offer and costs, not long term costs outside introductory offer, sometimes catching them out later
- Although charging less for some services, more for others overall evens out between them

Some do shop around, so what do they do?

"When I started off I just went to different banks to get information. Because everyone's promising this, promising that, and I thought, 'What the hell do I do?"
(Edinburgh Less Complex)

"Popping into the branches and picking up leaflets. We phoned a few of them on the telephone banking, the internet wasn't really a big thing when we started. So it was more just going into the branches and finding out what the charges were. We found that most of them were free for a year and then after that they sort of rack up the charges and everything."
(Birmingham Complex)

"My personal bank got flushed for quite a lot of money, through the internet, and one of the reasons I did go to HSBC was they offered a little fob thing at the time, to put a unique code in, and I assumed that that is more secure, and for me that is important."
(Leeds Less Complex)

"They have a little demo video online. I asked a couple of people who were with HSBC, and they said, 'Yes, it's all right'.
(Leeds Less Complex)

Any research is somewhat limited….

Finding a business bank is

- a necessary evil – have to do it / need it – bit of a chore

- an OK experience – one felt she got good service from a known (by sight) lady in the bank

- something you've got to have – so just get it done – quick / no thought / out of the way

-something I want to get over and done with as quickly as possible – you're expected to run before you can walk – i.e. how do you know what you're going to need and what level of transactions you're going to have?

Intimidating for the inexperienced – felt she was sold based on "this is what you're going to do – this is what (product) you're going to need…"

- not any real 'business advice'

They would (possibly) check on:

- **Charges**, and how they are structured – but actually most didn't do this (free banking)
- **Services** – a couple needed US$ accounts
- **Service** – someone to contact if you have a problem – at the lower end, a team of people is enough
- **Accessibility** – of a branch
  - If there are banks with branches near you, why would you opt for a bank without a branch near you – even if you weren't going to use the branch much?
- **Financial strength** – not going to go bust
  - Leads them to the 'known' brands (even though technically some of these did go bust!)

Any research is somewhat limited….

"You have to really dig deep to find out about what's out there, I've found, so it's not in your face like other things are."
(Slough Less Complex Start Up)

"In our case, we need to have a foreign, a US dollar account, so just generally what services do they provide?" (Slough Less Complex Start up)

"All you're interested in at the start-up of the business is how cheap you're going to get your account, after that you're not looking. You're not thinking about any two-year deal."
*(*Manchester Complex)

"We find also the location of your branch very important as well."
(Belfast Less Complex)

"*The security of the bank, which is a massive issue these days. You'd have to actually look at the bank itself, and make sure it was secure*" (Leeds Less Complex)

Elements of the Banking offer

Why is it that SMEs prefer a one stop shop?

Many SME owners organise their personal finance across multiple brands – PCA, mortgage, borrowing, credit cards, savings etc.

- But for their business, they tend to use the same Bank for everything

Why?

- Simply **haven't considered using multiple suppliers**
- **Easy, simple and convenient -** For themselves / for their bookkeeper / accountant / for HMRC
- They **get used to** how their banks' systems work
- Perceived **cost and hassle** of transferring money between banks, considerable risk factors if process do not work, including detrimental effects on their SME company image
- Underlying sense of **building a 'relationship'** with the bank which *may* put you in a better position either if things are going well (borrowing etc.) or if times are hard
- For most at the smaller end, there **is little perceived benefit** in spreading their banking activities between brands

As SMEs start to feel a greater sense of their own value (to the bank) and purchasing power they may see an opportunity to multi-bank or use multiple suppliers for different facets of the business, play one off against another to gain advantage

Why is it that SMEs prefer a one stop shop?

"The key's it's a relationship, isn't it? They actually know who you are, and your situation, and what you do, your financial status." (London Complex RS)

"I think if you wanted to set something up or you wanted to do something new, you've got more chance of getting it approved if you've been with that bank for a long time rather than keep switching here and there." (London Complex RS)

"I think it's difficult to then go to another bank. It's sometimes better the devil you know. Personally, I bank with the Bank of Scotland, and I stick with them because (1) I've been with them for a long time, and (2) it's so much hassle to open a new bank account. Everything, is done by email, and internet banking, So it's very rarely you actually have all these proofs of ID that they're asking for, and it's just far too much hassle to change"
(Edinburgh Less Complex)

"I've also learnt their system, learnt to pay with BACS and I've learnt to pay with faster payments. I've also had to modify my own way of working."
(London Less Complex RS)

*"What's the technical term for 'you can't be a***d?'"*
(Edinburgh Complex)

What’s the ‘real’ value of branches?

Relationship seekers

- The human face of the bank
- Ability to ask complex ‘human’ questions without needing to understand the ‘correct process’ and/or jargon
- Somewhere physically to go to if and when they have a problem – where they can’t as easily be fobbed off

Transactors

- Beyond paying in cash and cheques – not much
- Some do not use branches at all
- Others transact exclusively via machines / night safes
- Some like the comfort they could contact a human if needed to

NB: Amongst consumer audiences the physical branch network represents the financial strength of the bank and the safety/security of their funds* – it’s really not like that for SMEs though:

- The bank represents more of a channel than a destination (unless they’re saving for the business – but not all are)
- For some there is less of a sentimental view – possibly due to having to pay for banking services (whilst consumer accounts are ‘free’)
- For others the only face to face contact with the bank, a positive branch experience generates more warmth towards the brand
- Call centres and central numbers depersonalise the banks, distances SME further from branches

** Source: Stimulating Savings 2008 – BDRC Continental*

What’s the ‘real’ value of branches?

….a call centre in the middle of nowhere. They don't know who you are, and there's a lot of hassle that goes through, you're put on hold, and you're forever sitting on the phone for God knows how long. I like the old fashioned way, where you speak to somebody face-to-face. If that service wasn't available I'd move bank” (Birmingham Complex)

“Branches no longer have any control so it's irrelevant whether you know someone there or not, the decisions made in branches now ultimately come from credit in head office.” (Belfast Complex)

*“There can be certain issues which I need resolving there and then, and I refuse on a point of principle to speak to a call centre anywhere, especially if they don't speak proper English” (*Leeds Less Complex)

“When you go to somewhere and someone recognises you by name, I think you feel good, rather than just a number. I think it makes you feel that they do care and understand - care for you, for your business, as well as for themselves (Edinburgh Less Complex)

What is the 'real' value of the Relationship Manager for smaller SMEs?

A large number of smaller / micro SME's **no longer have an RM** – they either have a 'named point of contact', or more usually a team (of which this POC may be a part) and this satisfies their needs

The value of knowing someone in the bank or (more rarely) *at* the bank branch is that they have someone to turn to if there is a problem – a trouble-shooter, or require lending/OD advice

An equal number of SME's (both complex and less complex), often with less trading experience and less confidence, want better relationships with RM's (especially in the North-Birmingham, Manchester and Leeds) *"He never shows any interest, he never comes to see us, he never picks up the phone" (Leeds Less Complex Transactor)*

- More likely to perceive higher value of RM (even if not had one) and need to look at their account
- Some disappointed with calibre of young, inexperienced RM's whose focus is often to sell unwanted products such as Key man Insurance, not assist with day to day rates and smooth running of their accounts *'They've promised loads but delivered nothing, I've given up'*
- Some have switched banks due to poor service from their RM's, or have switched when no personal RM and it's become centralised
- These people want the competition authorities to encourage banks to ensure RM's are genuinely focussed to help SME's, to aid their under-confidence as often don't have time to assess their banking in detail *'I'm just trying to keep the plates spinning' (Birmingham Complex)*

What is the ‘real’ value of the Relationship Manager for smaller SMEs?

“I can phone him and ask him if I need an emergency overdraft just for a day or two, or if a cheque goes out and I didn't want it to go out.” (London Less Complex RS)

“I like having a single point of contact, I don’t like to phone a general number where nobody knows you, and generally I contact the business Relationship Manager by email, and I find that really convenient” (Edinburgh Complex)

“We always make the effort to go and see our clients, so that we get things right, and I expect that from the bank. If I'm doing it online, I could just be clicking on one product that is there because it's the one that I've navigated to, but it might not be the best one that would suit our business needs in the short-term, in the medium-term, or long-term.” (Leeds Less Complex)

“I've had meetings with two of these relationship managers over the years, and they've all been 21 years old, just out of university, have not got a clue. We're such a niche business that there are no stats they can pluck off the shelf and give us, so it's just an absolute waste of time.” (Birmingham Complex)

What is the 'real' value of the Relationship Manager for larger SMEs?

As businesses become more complex, they are more likely to have an actual RM – although even here, this resource is more stretched than at any time in the past (at the big banks)*

- For relationship seekers, value is trying to explain their business to the RM to help facilitate communications with the bank and make it more likely that they get what they want (whether lending or other facilities) or (in some cases) protect them from being forced into failure
- With mixed success
- Even for relationship seekers – the RM is NOT an adviser to the business
  - They simply advise on banking and banking facilities
  - They don't have the specialist knowledge or sector knowledge to genuinely add value beyond banking services
  - In a very few cases, the RM understands the local business environment – but this is increasingly rare
    - Some banks have a deliberate policy of moving RMs around to prevent relationships becoming too 'cosy'

*Turnover level at which businesses are designated their own RM has increased in recent years

What is the ‘real’ value of the Relationship Manager for larger SMEs?

“For understanding our individual businesses and needs, the service that they give us and the loyalty that we've given them and what rewards we'll get for it.” (London Complex RS)

*“To discuss cash-flow, and looking at the facility for the overdraft that we've got, and just a general lot of advice, and help with the pros and cons of different things that we've been doing. It's a fairly new business that we've taken on. So just having another person there to listen and talk things through has been great.” (*Edinburgh Less Complex)

*“Ulster Bank had actually implemented a policy whereby they moved people from their branches so that the personal relationship wasn't allowed to impinge” (*Belfast Less Complex)

“I think if you see a different person every time they don't know the structure of your business. You tell somebody one thing and then you'll probably have somebody else they don't really know what what's going on..” (Birmingham Complex)

This changing business banking offer doesn’t suit everyone

Servicing was universally personal / via relationships

Still available at top of SME market / corporate

Increased automation in branch and online for smaller SMEs

Fine for smaller simple businesses / transactors

Lack of advice and support which may hinder some SMEs

Most SMEs recognise the increasing automation of banking – and welcome the control it gives them

Losing the “personal touch” is more of an issue for some – whether an RM or the friendly face at the branch, distances them from the bank

The changing business banking offer doesn't suit everyone

"A lot of it is just nostalgia. I don't think there's any reason anymore to visit a branch of a high street bank." (London Less Complex RS)

"Unless you've got a personal point of contact it's a very negative experience" (Edinburgh Complex)

"They checked it there (cheque) and then, it was frozen and there's no need for us to go through the whole process. So that was a relationship, I couldn't have done that if I didn't know the person very well." (Belfast Complex)

"I do all my own debt chasing myself and to be honest the internet has replaced most of the hiccups in process, because actually it works quite well and I've got control. I can see so much more. I don't have to wait for a statement anymore. That's a huge advantage." (London Less Complex RS)

"It's quite handy to be able to go into a branch to get advice, person-to-person. Depending how important a subject is, sometimes talking to someone over the phone can be a bit time-consuming, and they can't really see your position, and sometimes it's easier - I think you understand people better when you look face-to-face, you know what's going on" (Edinburgh Less Complex)

Has banking changed for the better?

Transactional banking is way of life for most, more confident SME's (10 yrs + trading) adapted better

- Some hanker after point of contact but learnt to adapt without one
- Written communication provides information (re rates etc) but for many not as useful as talking to someone.
- Often convoluted regulatory pages of explanation, mask the **important bits**

Some SME's (often less trading experience) less confident, dislike impersonal nature

(especially Birmingham, Leeds, Manchester)

- More angry not looked after and left to work it out themselves
- Want banks to be more proactive: quarterly reviews, 'how can we help" interaction (phone, face-to-face) not letter or email
- Not focus on control and compliance

Has banking changed for the better?

"I wish it had been more personal. I wish I would have gone to a branch rather than doing it the easy way of doing it by mail, et cetera, definitely" (Manchester Complex)

I've never found them (RM's) proactive in anything they do so to me they're a bit of a non- entity" (Edinburgh Less Complex)

"I banked with Yorkshire Bank because years ago you used to get looked after very well. Again, it's that personal touch, which is not existing now, so we might possibly be changing."(Leeds Less Complex Transactor)

"We hate call centres [when] people can't understand what you're saying." (London Less Complex RS)

Changes in need and expectation (for some)

For many SMEs banking needs do not change over time and remain simple

However, there are a number of **trigger points** for the business which **might** lead to their banking needs changing

- Need to borrow
- Need to employ more staff/ growth
- Starting to trade internationally
- Need to fund growth, e.g. invoice finance / asset finance
- Employing a financial specialist
- Diversify business in another area

Even here, most continue to use their existing bank for these additional services – but from what larger, more complex SMEs say, some will see this as an opportunity to look around

- They begin to see themselves as an attractive proposition for the banks, and have more confidence, some run 2 banks to divide operations and maximise bank facilities

The alternative is that their bank either fails to deliver some of these additional services or refuses to offer them – in which case they might look around for alternatives

Changes in need and expectation (for some)

“Well we've got two divisions of the business, but we've never made it a secret because originally HSBC were very difficult a long time ago with some problems that we had. I set up another business which was with RBS, that was a referral through an accountant. That worked extremely well because once we got back on the straight and narrow, we play one off against the other” (Birmingham Complex)

“You've got the experience of two different banks can offer two different things. Also with the challenges ahead, one bank might be able to help you more than the other.” (London Complex RS)

“Literally, we were looking for investment in some new plant, so that's [the] machinery side of things, for the factory, and just the guys that we were banking with didn't see it our way (NatWest), and another bank did, (Yorkshire Bank) and that was it.” (Leeds Less Complex)

Switching

Choosing a (new) bank for your business is like…..

Leaping in the dark*

- Exposing yourself to potential danger

Utility companies* – they're all the same

Mazes* and minefields* – perceptions of complexity/ pot luck

Finding a friend you can trust / someone to look after your children / to control your future

You can have any colour as long as it's black!

A beauty parade where everyone is hideous and they're all wearing masks

Jumping off a moving train on the Forth Bridge

Trying to play tennis in the dark

*During the workshops, respondents were asked to select images which expressed how they felt about choosing a new business bank

Choosing a (new) bank is like…..

"Well it was a leap of faith, obviously we trusted our accountant, he'd done a lot of the research but also you never know until you're actually in a relationship whether they're as good as you hope they're going to be". (Birmingham Complex)

"Choosing your winner at the Grand National, It's really a bit of pot luck, because they're changing their circumstances weekly, monthly, yearly." (Leeds Less Complex)

"It's like a walk in the park because it was quite easy to find a bank and do my research online, saw one or two bank managers and got set up very quickly; it was fine" (Belfast Less Complex)

"Like walking a greasy tightrope because every day you're hearing negative comments about the major banks. I just think if you were looking for a business bank now, it would just be a leap in the dark. I don't know what you would base it on these days." (Manchester Complex)

"It's like choosing a partner; you need to trust them." (Belfast Less Complex)

Do they jump or are they pushed?

Switching is very limited amongst SME's
- less than 5% switch banks or use more than one bank*
- mixture of complex and less complex businesses

From what SMEs told us, most switchers (certainly first time round) have to experience one or more strong push factors

One monumental mistake or a series of annoying mistakes

Erosion of trust:

- facility withdrawn / refused

- excessive / unreasonable charges

Lack of help in resolving issues

Appearing not to 'care'

Few are driven by pull factors – although a few mentions of 'beauty parades' at the top end

*Source: SME Finance Monitor 2013

Do they jump or are they pushed?

"You stay with your bank until they screw up, and then you probably go in wide-eyed to a new one, until they screw up, and then you move again." (London Complex RS)

"The service was just so diabolical so I switched" (Edinburgh Less Complex)

"To be perfectly honest with you they couldn't have cared less. Honestly. They never even rang us to see why we were changing or anything." (Birmingham Complex)

*"I got a really big order and I just needed a small overdraft to buy in equipment and install it, and they wouldn't give me it, or they would give me a tiny little overdraft and wanted me to secure it against my house and pay legal fees. It was just a farce. I can't remember how much it was but it was £4000 or £5000 and it would have cost £1000 of legal fees just to draw up the agreement" (*Edinburgh Complex)

Why do people stay with their existing bank

During the groups, respondents were asked to select images which expressed how they felt about staying with their existing bank

Happy with service
Feel you're being supported

Some want to feel that the bank is a 'partner' (even if they aren't really)
You remain faithful to a partner….don't you?
You want the relationship to work

Better the devil you know….

Feeling trapped

Unable to see an alternative – can't see the light!

Why do people stay with their existing bank?

"I think our relationship with a bank is that we're like an old married couple now. We kind of run along together pretty well. We don't have any major fallings out so divorce isn't on the cards for us." (Birmingham Complex)

*"Because it's not going to save me millions. It's not going to make a huge difference to my business financially, changing. But the impact if it [switching] went wrong would be much bigger." (*Edinburgh Less Complex)

"Once you get used to how a bank works especially online, it's just habit and it's not a big deal to change, but I just think it is a preventative just knowing the system and just seeing it's the last thing you want to have to think about." (London Less Complex RS)

"You want to stay because you don't really know what's out there if you move. It's easier to just bury your head in the sand, and just go along with it. You feel like you're trapped in a box and you can't get out." (Manchester Complex)

Why do (would) people move to another bank?

If you felt trapped
If there was a bad fit for some reason
If the relationship was broken or impersonal

If another bank is offering opportunity or they are seeking something more

If there were anything tangible to gain – most unsure what this might be, free banking

During the groups, respondents were asked to select images which expressed what would make them switch to a new business bank

Why do (would) people move to another bank?

“If they had service level agreement….my guarantees as to why they’re brilliant'. The banks don't do that. They just constantly tell you how different they are.”
(Leeds Less Complex Transactor)

“Either extremely bad service; it'd have to be extremely bad, or they withdrew a service that you needed”. (Slough Less Complex Start-Up)

“every time you go in, you're just a number, you get a different face and there's no continuity with your last conversation”. (Belfast Less Complex)

“If they gave me something, like a credit-card machine with no tie in contracts”
(Edinburgh Less Complex)

Differentiation is difficult in business banking

In the research, we observed that SMEs found it extremely difficult to differentiate banks across dimensions of price, quality and range of services

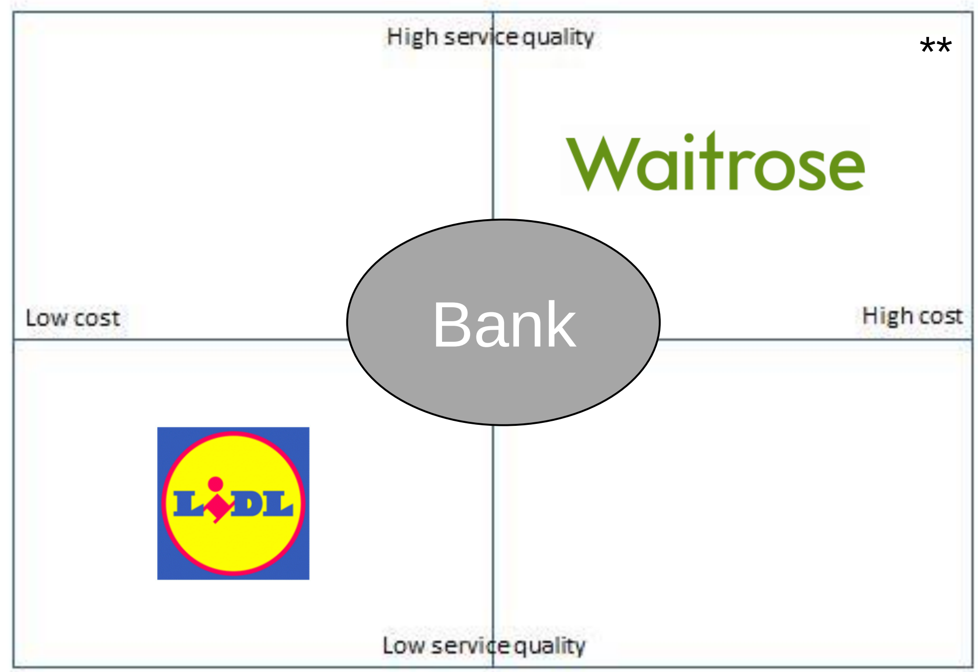
Their responses were based on:

- Anecdote – *"my dad uses Barclays and…"*
- Brand / advertising
- PCA experiences and current business bank

A (very) few common threads about brands:

- HSBC more international
- Santander service 'mixed' – but low cost
- Danske bank uplift in quality (NI)

Metro bank new and different (sandwich toaster to new BCA customers), but SMEs were not sure where might fit on the dimensions suggested



**as part of the research respondents were asked to map the banking brands they are aware of across different dimensions. Some observed that this would be much easier for consumer brands such as supermarkets where there is clearer differentiation.

Differentiation is difficult in business banking

"They all seem to be the same. They've all got their offers, they've all got the bolt-on's, and add-ons, and all the rest of it, but generally, one way or another, they come at a cost long-term." (Manchester Complex)

"I would have thought (HSBC) they were pretty good (service), because they have international bases don't they? Hong Kong and Shanghai Bank, isn't it?" (Manchester Complex)

They (HSBC) are so much all over the world and they're all over the place and they're very international, so actually for a business that's running export or dealing with foreign currency they might be very good." (London Less Complex RS)

"…oh my god, don't go anywhere near Santander'! and I'm like, 'Oh, I've been all right with Santander'. I think it is personal experience", (Slough Less Complex Start-up)

"Metro don't have internet banking. There's not many branches as well but it's something that I've wanted to look into" (*London Complex RS)

"In reality they are only minutely different" (Leeds Less Complex Transactor)

*Factually incorrect perception as Metro does have business internet banking

SMEs felt that business banking is not differentiated in the way that, for example, supermarket shopping is

Supermarkets		Banks
Personalities, characters		Experience dictates perception
Clearly differentiated product ranges	**Vs**	The same products
Aim for different target audiences		All things to all men
↓		↓
Clear niches in market place		No clear divisions, no SME only bank

Do people know what their bank charges are?

Most (complex and non-complex) aware of **own charges** (not off the top of their heads and not the detail)

- Most feel charges at own bank are transparent (viewable online / appearing itemised on statements)
- Few shocks and surprises, except for some when out of introductory offer where higher costs are in small print
- Some costs rankle (e.g. cash), but they acknowledge that this is ‘the way it is’

When it comes to **other banks** awareness is much lower

- Another bank may be cheaper – but they just don’t know
- Very difficult to compare like with like (particularly for larger businesses)
  - Particularly if there are OD or loan rates based on individual business risk
- General assumption that there is not much of a saving to be made by looking around
- Also – difficult / impossible to assess the service that comes with the price

With regard to checking on competition in the market:

- Very low awareness of any aggregator sites to help…..
- ….which further illustrates that most JUST DON’T LOOK!

Do people know what their bank charges are?

"I just don't know of any sites where you can compare" (Manchester Complex)

"The way websites are, they all have the different levels of accounts, and then you go to another website, and try to compare the two, or three, it's difficult." (Leeds Less Complex)

"It's extremely transparent for me." (London Complex RS)

"I haven't got a clue what other banks charge. It's something that we need to look into but I haven't got the time and I always presume it's always going to be the same." (Birmingham Complex)

"We've got everything in black and white. We know exactly what the bank charges are" (Edinburgh Complex)

Lending / shopping around for lending

Only limited experiences of this (mainly amongst more complex businesses)

General view that it is more difficult to get finance now than previously

Main bank would be first port of call (they know you and your business – *should* make a difference)

- If asset or vehicle finance required (i.e. other securitised lending) they may go elsewhere to a specialist who may be more competitive these days (e.g. vehicles)
- We know from other work that few will even approach another lender if their BCA bank turns them down for lending – they don't expect to get a different answer "*If the computer says no" (Leeds Less Complex Transactor)*

The potential downside of lending is that it can act as a 'lock-in'

- Practically – the bank may call in the loan if you switch BCA
- Emotionally – you feel more vulnerable to your bank – this alone may prevent you from looking elsewhere (in extreme cases, you don't want to risk offending them)

Lending / shopping around for lending

*"I'd have that mentality that if one says no the others are probably to likely say no as well." (*Leeds Less Complex Transactor)

"I think their appetite for risk has got to improve. Previously it was just like 'What do you want? On you go', but nowadays they're far too conservative in their lending"
(Edinburgh Complex)

*"You tend to find you get easier lending with the bank that you're currently with than you would with a new lender because they know you." (*Birmingham Complex)

"Even if that loan is say a two year loan, they can actually call it back anytime they want, and most people don't appreciate that they can do that"
(Leeds Less Complex Transactor)

In the regional groups (Manchester, Leeds, Birmingham), SMEs highlighted access to credit as an issue

In these regional groups, smaller and micro SMEs in particular felt that there were barriers to them borrowing from banks.

- If PCA account healthy and BCA with same bank, some told to use those funds and not granted a business loan (although some felt that a healthy PCA with same bank as BCA is felt to aid the bank's confidence; 'they know how much your house is worth')
- Lending felt to be far more complex these days, exacerbated by being highly regulated, leading to reams of regulatory notes to wade through

In order to get around this, they adopt alternative strategies:

- PCA loans for car/machinery, felt to be quicker and simpler than business loans
- Borrow money from family (usually parents)
  - Even those with quite large turnovers, but short-term cash-flow issues (e.g. Pay wine merchants) are doing this

A few larger businesses in these regional groups provided anecdotal evidence of companies gaining European loans (e.g. from Germany - £95k for machinery) and that these were approved faster than in the UK

- Some of these larger SMEs we spoke with were using or considering private investors

Lending Barriers

"…to buy a new vehicle, you used to be able to make a phone call, put your funds in place, and have it all arranged. The time it now takes you to finance anything in this country is unbelievable, no matter how long your relationship is with your bank or how good your credit is. It's just a nightmare; they want to know everything about it, and it takes too long".[a month] (Manchester Complex)

"the bank wouldn't give me any money, so I borrowed from the credit union" (Belfast Complex)

"It's too risky for a bank. I wouldn't even approach a bank, because I just know it's too risky for them, because it's investment capital in a start-up, and it's just not the banks' cup of tea at the moment". (Leeds Less Complex)

"I've got friends that have got big businesses, big manufacturing businesses, and they're now borrowing from Europe for machinery assets because it takes that long to get any money." (Manchester Complex)

Regional issues – Northern Ireland

Northern Ireland truly feels like ‘a different country’ with regard to some of the central themes of this research. From what SMEs there told us:

- Market much more affected by the severe economic pain of the South (Eire) including the rise and fall in property values (domestic and commercial)
- The extreme measures taken by the banks to address their own insolvency
  - Sudden and unexplained rises in interest rates for loans / overdrafts
  - Sudden removal of overdraft facilities
  - Sudden *hostility* towards particular sectors – i.e. construction / building (went from throwing money at these sectors to applying severe restrictions to anything connected with these sectors)
  - Knee jerk / panic / crisis reactions taken centrally and using a broad brush approach
- Lack of competition historically – although Danske Bank felt to be shaking things up a bit
- Tradition of ‘not switching’ – anecdotally, people don’t switch – they stick with what they know
  - Perhaps tied into the sectarianism of the past? (see slide 10)

Regional issues – Northern Ireland

“Ulster Bank. They weren't really interested at any level because of the sector I was choosing to go in to, it was obviously a sector that had been downgraded and they had no interest in hospitality.”
(Belfast Complex)

“What has happened in the last three to four years, for most people who have borrowing, even those agreed rates that have been out there have been increased because the banks are saying they have to increase their margins.
(Belfast Complex)

Regional issues – Birmingham, Manchester and Leeds

A number of SME's in the north (Birmingham, Manchester, Leeds) fondly recall local small brand regional banking (Yorkshire Bank, Alliance and Leicester, Williams and Glyns)

- Personal service was key
- Local branches enabled this as friendly, small banking ethos
- Especially among RS, mix of smaller and larger SME's

Take-overs, amalgamations has reduced this warmth towards the brands

- Yorkshire bank grown to degree now has central call centres, led to some switching to receive RM with another bank as 'scripted' 'impersonal' service does not match their requirements
- Others have learnt to adapt but some not happy about doing so
- These SME's tend to be more traditional and hanker for the good old days
- Some more angry and disappointed no longer receive such personal service

Regional issues – Birmingham, Manchester and Leeds

“I think there should be a lot more contact. If you're putting vast sums of money through a bank, serious amounts of money, then you should be getting a phone call once a month or something, just to say, 'Hello‘ *(*(Manchester Complex)

“I don't feel I have a relationship with them. When I said to them on Wednesday last week, 'Well, I think I'll move because you're charging me fees, and you never told me', they said 'Fair enough’.
(Leeds Less Complex)

“When I had a previous business I had a relationship manager, and that's why I'm quite confused why nothing like that exists within my world now, and I found that quite useful, that personal touch.”
(Manchester Complex)

Conclusions

Are SME's willing and able to switch banks?

- Some have, some review the market – they will switch if there is a major problem/charges become too high
- Or if offered a good enough incentive e.g. Free banking (a few)
- However, there is low salience of business banking; perception that all banks are the same – it's a bit of a leap in the dark

  "There is no compelling reason for us to move"

- Most don't actually want to switch / multi-bank if they can avoid it:
  - There is comfort in the 'known' and a degree of 'loyalty'
  - There is still some fear in/of the bank and unwillingness to upset it – particularly if borrowing involved
  - There are few *perceived* benefits (financial or otherwise) as all banks are the same *'different cheek, same a**e' (Leeds Less Complex)*
  - Can earn the same amount of money for time spent trying to switch that could save in costs
  - From actual switchers, the principle benefits are intangible / service related (which has to be experienced to be evaluated) – although some do make cost savings on specific elements of the new deal

Are SME’s willing and able to switch banks?

“I think if there was a trigger, if they really upset us over something then we would consider voting with our feet but it's easy to stay where we are.”
*(*Birmingham Complex)

“Well, I'm not happy with the situation, but I don't see the benefits of switching being that big. If I switched at the moment, I'm sure I could find a bank that didn't charge me, and I might save £100 a year. I could probably earn £100 in a couple of hours if I put my mind to it to make that anyway.”
(Leeds Less Complex)

“The reason I wouldn't switch is because I'm not convinced there is anything out there better, and that's the only reason. If I thought there was something better, I'd probably go through the pain to do it”.
*(*Leeds Less Complex Transactor)

Are SME's willing and able to switch banks?

- Low awareness of 7 day switching – and those that know think it may not apply to business
  - Fear of 'legacy' issues – only a few knew that it was up to the old bank to redirect payments and inform payees of the new account details
  - Leads to perception of high level of difficulty involved in switching
  - Once aware created interest, especially if banks will honour any financial mistakes during the transition
  - Some concern in Leeds/Manchester whether even investigating switching would adversely affect credit score
  - Actual experience of switching (as with PCA experiences) is mostly positive– so those who do switch would be prepared to switch again
  - 2 Less Complex SME's in Leeds complained about the 4-6 weeks delay in receiving all relevant documentation such as paying in books and cheque books

Are SME's willing and able to switch banks?

"Just fear of everything going wrong, everything that's been set up and the relationship that's been built over the years, all just coming crashing down and just sort of like months and months of trying to sort things out"
(Manchester Complex)

"It was reasonably easy. Fortunately these days, they do tend to work together, whereas previously they never used to. To move from one bank to another was always very difficult, especially when you've got lots of standing orders and direct debits, but it was relatively easy".
(Leeds Less Complex)

"The emotional side, when to do a major change like that, you feel like a fish out of water as everything you know has changed. Different numbers, web addresses, different codes"
(Edinburgh Less Complex)

"The switching is easy. The legacy of trying to get all your customers - you've got longstanding customers with many branches you pay independently, it's trying to get them all to pay your new bank and that can take years."
(London Complex RS)

Who are most likely to switch?

- Different levels of switching. Very low in Belfast, Manchester and (logically) the start up group. Around 1 in 3 amongst the other groups.
  - Majority 10+ years trading experience so more confident
  - Most had between 1-15 employees so less complicated PAYE systems etc
  - Range of industries
  - Range of complex and less complex businesses with differing turn-over levels
- Most reactive to poor service/high charges
  - A few advised by accountants to switch
  - One received a letter from the Federation of Small businesses advising them of free banking with the Co-op
- A few have switched to gain an RM
  - Either poor service from current one or centralisation of call centre from existing bank when had one

How, if at all, does the RM impact on switching?

RMs are not what they used to be!

- For some, they can be an important part of the existing relationship and part of the reason for staying or switching
  - For the SMEs we spoke to with good relationships, this was considered a ‘value add’ and worth paying a little extra for
  - No evidence that anyone was hanging on to their bank and paying over the odds, just because of the RM
- But many just don’t have this level of ‘relationship’
- No evidence from this research that an RM (or other staff member) has become so valuable that they have become indispensable to the business (and lock out competition)
- There is a view that longevity of relationship *may* help when you need to borrow (both access and rate). But it’s felt that this doesn’t count for as much as it used to
  - Indeed, an observation was made by a few SMEs that the overall banking experience (particularly on the personal side) has moved towards penalising loyalty and rewarding promiscuity – and they therefore expect this to spill over into business banking

How, if at all, does the RM impact on switching?

"We have had issues similar with the relationship managers in the past where they have been unable to represent us correctly and get what we need from our bank, and we had to change bank. If we get relationship managers that we're unhappy with, we will get them changed until we get somebody that provides a service, so we're loyal to the relationship manager we don't mind him."
(Edinburgh Complex)

"Yorkshire bank I had one (RM). They decided 12 months later to move to Glasgow, I was speaking to a nameless, faceless person who was reading off a script. I said, 'Well, the best thing, why don't you come and see me?' She said, 'I'm in Glasgow'. I said, 'Ah, there lies the problem'. I said 'You haven't got a clue what I do, what my business is about. All you're doing is reading from a script'. She said, 'Well, I'm sorry, that's all I can do'. I said, 'Well, the best thing to do is for me to move my account'. They never even contacted me to ask why. I closed all nine accounts and moved them to HSBC."
(Leeds Less Complex)

"For understanding our individual businesses and needs, the service that they give us and the loyalty that we've given them and what rewards we'll get for it."
(London Complex RS)

Barriers to new / smaller banks

1. **Awareness, awareness and awareness!**
2. Presence – for those who need a branch near them
3. SMEs views (or lack of them) around the benefits of switching
4. Other issues; size of network, stability, charging etc. pale into insignificance compared to the dimensions listed above

SMEs are not *against* considering smaller banks - many (particularly in NI) express the desire for new entrants to come in and 'shake things up'

- A SME business only bank suggested (in Leeds)
  - Must understand SME needs, including that some want RM's and that some don't depending on nature of their business
  - Some discussion re entrance of 'Bank of Dave' in Lancashire as interesting idea but need to find out more about it

Barriers to new / smaller banks

"I think if the bank came into the market, for me, and we're different obviously, and it was online bank, but the personnel that were dealing with you were trained in business, and it was more specifically geared to business needs, I think I'd very seriously look at it." (Leeds Less Complex)

"They are all the same. The only way that it will ever change, really, is if you had smaller banks coming along, they could offer a different service" (Leeds Less Complex)

"You need three or four new players in the market to give us options and shake things up."
(Belfast Complex)

"You'd have to investigate it more" (Bank of Dave)
(Leeds Less Complex Transactor)

Barriers to new / smaller banks

We did not uncover any evidence from SMEs of bigger banks conspiring against smaller banks for business services

- Newer entrants also are offering free banking (and a sandwich toaster!)

We did find the odd example of smaller banks losing services in the process of being absorbed by a larger bank (Allied Irish moving services to a call centre – which led to one SME switching in NI)

Service failure drives much of actual switching, so bank willingness to negotiate on charges is unlikely to retain an SME deciding to switch.

The majority of smaller SMEs do not require 'a full suite' of banking services – they need transactional banking that is easy, quick, efficient, reliable and inexpensive.

- The BCA is, however, central to the overall banking offer
- And there is a perceived link between the BCA and bank finance availability

Is existing lending a barrier to switching?

We didn't come across anyone who had tried to switch but found that their existing borrowing / securitised borrowing specifically prevented or restricted this…

- However, this was felt to be a barrier to switching by a few of the larger, more complex businesses
  - Financially – legal costs of moving debentures etc.
  - Practically – finding another Bank (or lender) willing to take this on
  - Emotionally – almost feeling afraid to look (in NI)
- Credit history / rating for SMEs is not felt to be transparent, and that rating agency data is only a partial truth
  - The incumbent bank *does* hold more information via the relationship and is better able (from their perspective) to judge risk

"If you're locked in, tied in by way of borrowings as well, you have no choice but you have to stay. There's substantial cost in taking your collateral or security from one business to another, because you're having to change mortgages or debentures, or whatever, so there is quite high legal costs there. You need to bear in mind if the gain is worth more than the pain." (NI – Complex RS)

Is existing lending a barrier to switching?

"I've never had sense of the bank as being fair with you".
(Belfast Less Complex)

"If you're locked in, tied in by way of borrowings as well, you have no choice but you have to stay."
(Belfast Complex)

"But if you're actually looking at change within your business, for good or worse, at the moment it's like who do you talk to?"
(Belfast Complex)

"My dad's bank is Ulster Bank for 50 years but they've been treated so badly by Ulster Bank in the last year or so that they're trying to move. The issue with them is they're in the building trading so no bank wants them because of the building trade, even though they're a profitable and good business."
(Belfast Less Complex)

"You just feel fragile and you feel that the banks are not in a very good position and that compromises the ability to grow and your building function".
(Belfast Complex)

What can be done? – *customer ideas*

SMEs participating in the focus groups were asked an open question about what changes they would like to see. Their answers are summarised on this slide and the following slide

Encourage more transparency:

- Simplistic charge scales with short, straight forward descriptions of rates and fees
- Prevent banks from unfairly leveraging the PCA relationship (i.e. transferring funds without permission)

Ensure greater awareness of:

- 7 day switching/Guarantees
- aggregator sites for business banking

Introduce regulations which aid switching:

- Ability to port account number when switch
- Minimum time period for decision on lending and length of time it can be accessed
- Service level agreements, guarantee services, reviews etc

Shake the market up/differentiate:

- Support and encourage new entrants, using 3rd parties like Federation of Small businesses
- Enourage specialisms in sectors/ industries e.g. Retail
- Encourage wider range of BCA and finance providers

Encourage banks to be more proactive:

- Highlight those which genuinely invest in RMs targeted at SMEs
- Demonstrate success stories of switchers and new lending

What can be done? – *customer ideas*

"Providing your business in terms of your daily running of the business doesn't change dramatically, that once the banks say, yes, to that overdraft or that loan, it's that that's guaranteed for a period of time"
*(*Edinburgh Complex)

"The banks have got to specialise, the needs of the motor trade are different from the hotel trade, different from the chemical industry and we're just not on the same… You know, you can't just pigeon hole us, your business in that sense."
*(*Edinburgh Complex)

"Need to show people process has been simplified.They have to get some celebrates and some success stories out there to say 'this was simple for me to do', I don't think they do enough of that" (Switching)
(Manchester Complex)

For further information

Richard Smith
Head of Qualitative Research

+44 (0) 20 7400 1018

+44 (0) 787 5549065

Richard.Smith@bdrc-continental.com

www.bdrc-continental.com

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Shares of supply of BCAs across SME turnover segments in Scotland and Northern Ireland

FIGURE 1

Scotland

[✂]

Source: All figures are based on Charterhouse release for Q2 2013.

FIGURE 2

Northern Ireland

[✂]

Source: CMA/FCA analysis of data from the PwC Northern Ireland Business Banking Tracker, 2012.
Note: There is relatively low base size of 98 respondents for the ‘more than £5m’ turnover segment.

International comparisons

1. During the market study we have considered how the characteristics of the SME banking markets that we have considered differ from those in other jurisdictions. However, in undertaking the following analysis, we have also been mindful of the ICB's conclusion that:

> In general, it is difficult to compare across countries as their histories and competitive dynamics differ (for example, in some countries regional banks are the norm), and there are few comparators with similarly sized markets that also have national bank networks.[1]

2. Despite these challenges, we have identified various potential sources of relevant information:

- The **2007 European Commission inquiry into retail banking markets**, which showed aggregate market shares (or concentration ratio) for the three largest banks in a country (known as the CR3), and for the five largest banks (CR5). The study did not split the analysis for relevant product markets (eg liquidity management services for SMEs) or relevant geographic markets (eg Scotland), but assessed retail banking as a whole, including personal banking, for a particular country. The study found that, on the basis of these measures, the UK had a very close to average CR3 and a relatively high CR5. It was less concentrated than countries such as Belgium, the Netherlands, Finland and Sweden. However, it was more concentrated than countries such as Italy, Spain and Germany.[2]

- **Information from the ECB** estimates relative levels of concentration for the 27 EU member states. The ECB study ranks the UK 23rd out of the 27 EU member states with an HHI of 436 for UK credit institutions in 2012 and the top five credit institutions having a share of total assets of only 40.6. These figures are significantly lower than the estimates provided earlier in Chapter 4 and appear to reflect a differing methodology such as the inclusion of large investment banks mainly located in London whose activities have little relevance to our current market study.[3]

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[1] ICB report, paragraph 7.15.
[2] European Commission (2007), Report on the Retail banking Sector Inquiry.
[3] ECB published concentration statistics.

- **Information from the World Bank.** The World Bank's estimates also show the UK having one of the lower banking concentrations in the EU. However, this analysis also relates to a wider range of product markets than those considered in this market study.[4]

3. With respect to information obtained via the ECN and meetings held with other national competition authorities in other jurisdictions, the following points on market concentration can be made:

   - Germany is sometimes considered as a market with more effective competition than the UK and it appears to be the case that concentration levels for SME banking in Germany are lower than they are in the UK. We understand from the German Bundeskartellamt that this is a consequence of the strong regional and local focus of the German banking sector featuring a large number of smaller banks of varying ownership types. Therefore, national market shares in Germany may not be a meaningful comparator and German local markets may be quite concentrated in nature.

   - National concentration levels in the USA also seem to be lower than they are in the UK. We understand, based on our discussions with the US Department of Justice, that historical branch restrictions imposed on US banks might have contributed to more fragmented markets in the USA. Although these laws were relaxed around 20 years ago, their lingering effects may explain the lower concentration level when the USA is considered as a whole. On the other hand, the US banking and antitrust authorities often have found competitive concerns in local banking markets, and have sought remedies when the HHI of a proposed merger is greater than 1,800 and the merger is determined to raise antitrust concerns.

[4] World Bank (2013), Financial Development and Structure dataset.

Business deposit accounts

1. Alongside our consideration of BCAs and loans, we have also briefly considered business deposit accounts (BDAs). In doing so, we have particularly focused on whether that product displays different dynamics from the focal products.

2. Our analysis suggests that a critical element of the dynamic that we refer to in Chapter 4 exists in relation to BDAs. That dynamic is the so-called BCA ‘gateway effect’. In particular, we find that:

   - 91% of SMEs with instant access BDAs obtain those from their main banking provider

   - 81% of SMEs with a term or notice BDA obtain those from their main banking provider.

3. Indeed, one major bank indicated to us that around 95% of its SME customers with a BDA also held a BCA with it.

4. This provides the main banking provider with a strong ‘first port of call’ advantage over other providers, consequentially limiting the intensity of competition for those products.

BCA pricing

1. In this annex, we consider the prices charged by various BCA providers. In doing so, we focus particularly on the extent to which we observe dispersion across prices between different providers. This is relevant because it may be consistent with the exercise of market power by certain firms by indicating that such prices are not constrained by the prices offered by other providers. Moreover, the existence of such divergences would indicate that customers may be unwilling or unable to switch to take advantage of better offers, something that would not be consistent with a well-functioning market.

Analysis

2. We have considered ten different SME transaction profiles, based on transaction profiles provided to the CMA and FCA by one bank.[1] We used published information on bank tariffs from *Business Moneyfacts*.

3. Table 1 below shows the differences between the minimum and maximum interest rates paid on BCAs by the largest four banks in Great Britain and the smaller banks.[2] It is evident that the maximum interest rate that smaller banks pay is approximately five times more than that of the largest four banks. It is also evident that smaller banks are, on average, likely to pay up to five or six times more than the bigger banks. However, in absolute terms, given the low interest rate environment, the difference in interest rates paid between smaller and larger banks is marginal.[3]

TABLE 1 **Comparison of the interest rates paid by the largest four banks in the UK and smaller banks (as at April 2014)**

	Credit balance on the account					
	£10,000		*£100,000*		*£500,000*	
	Smaller banks	*Larger banks*	*Smaller banks*	*Larger banks*	*Smaller banks*	*Larger banks*
Min interest rate	0	0	0	0	0	0
Max interest rate	0.25	0.05	0.25	0.05	0.28	0.05
Average	0.05	0.01	0.06	0.01	0.06	0.01

Source: CMA/FCA analysis of *Business Moneyfacts*.

[1] [✂]
[2] These figures are unweighted.
[3] It should be noted that some banks, such as Carter Allen, offer interest rates around 3% but are not included in this analysis as they are relatively small.

4. In addition, the findings shown in Table 1 do not differ when the smaller banks across Great Britain are compared against the largest four banks in England and Wales[4] and the largest three banks in Scotland.[5]

5. With respect to interest rates charged on overdrafts, many SMEs negotiate their terms of the overdraft facility with the bank and, as such, no comparison can be made across banks.

6. Next we consider transaction pricing to established customers. The analysis considers two broad types of SMEs depending on the primary channels through which they bank. Therefore, half (five out of ten) of the scenarios relate to customers who conduct the majority of their business banking through electronic channels (Internet and telephone banking). The other five scenarios consider customers who are modelled as having a greater need to transact their banking in branches.

7. In general, SMEs transacting through direct channels will face lower BCA transaction fees than those seeking to transact through branches. The published tariffs of banks by *Business MoneyFacts* were used. Tariffs which are available in Great Britain generally apply equally for Scotland, England and Wales, so there is no difference in the banking costs to SMEs across the different scenarios.[6] In contrast, the Northern Irish banking market has a different set of major banks, and so a different set of tariffs from those offered in Great Britain.

8. We set out in detail the transaction profiles we have used for the tariff analysis below. We also set out details of the tariffs and how the banks compare in terms of their tariffs across the ten different transaction profiles we have used.

Comparison between smaller and bigger banks

9. Table 2 shows that for all scenarios, on average, the smaller banks offer cheaper tariffs to SMEs when compared with the largest four banks (across their different brands) in Great Britain.[7] The percentage difference between the averages for the larger and smaller banks differs across the scenarios. Table 2 shows that the cost to SMEs with a scenario 1 transaction profile is 12% higher when comparing the average across the largest four banks relative to smaller banks. In contrast, this difference is only 2% for SMEs with

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[4] For England and Wales, the four largest banks by market share, are HSBC, RBS, Lloyds and Barclays.
[5] For Scotland, the three largest banks, by market share, are RBS, Lloyds and Clydesdale.
[6] RBS is the only bank which offers a tariff targeted at Scottish customers which differs only slightly from its England and Wales tariff rates.
[7] The following brands have been grouped as follows when referring to the largest four banks in Great Britain: RBS and NatWest, Lloyds and Bank of Scotland, HSBC and Barclays.

a scenario 6 transaction profile. Similarly, if a weighted average[8] of the largest banks is compared against the average of the smaller banks, it can be seen that the percentage difference between the smaller banks and the largest four banks in scenario 1 is reduced to 6%. In contrast, the percentage difference for scenario 6 increases to 5%.[9]

TABLE 2 **Comparison of the tariff offerings of the largest four banks and smaller banks**

	SME transactional profile									
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
Average smaller banks (£)	9.54	10.87	13.46	14.55	23.14	18.28	30.43	45.62	55.92	71.67
Average smaller banks (excl Santander) (£)	10.07	11.52	14.36	15.55	25.01	19.18	31.93	48.85	58.91	76.42
Average big 4 banks (£)	10.71	11.72	14.27	15.36	24.42	18.66	34.20	50.81	64.70	82.08
% biggest 4 banks are more expensive on average	12	8	6	6	6	2	12	11	16	15
Weighted average biggest 4 banks (£)	10.07	11.19	13.93	15.07	24.74	19.17	34.34	50.47	64.65	80.52
% the weighted average of the biggest 4 banks are more expensive	6	3	3	4	7	5	13	11	16	12

Source: CMA/FCA analysis of *Business Moneyfacts*.

10. Table 3 shows that the largest four banks in England and Wales, and the largest three banks in Scotland by market share, are comparatively more expensive compared with the smaller banks.[10] Table 3 shows that the cost to SMEs with a scenario 1 transaction profile is 23% higher when comparing the average across the larger four banks relative to smaller banks. In contrast, this difference is 19% for SMEs with a scenario 6 transaction profile. Similarly, if a weighted average[11] of the largest four banks is compared against the average of the smaller banks, it can be seen that the percentage difference between the smaller banks and the largest four banks in scenario 1 is reduced to 20%; while the difference for scenario 6 increases to 27%.[12]

[8] The weightings are based on the number of active BCAs as a proportionate split of customers across the different tariffs offered by the bank.
[9] The Barclays ePayment and RBS Business Banking Direct tariffs may be seen as 'outliers' which influence the average of the largest four banks, where the RBS Business Banking Direct Tariff is excluded from all scenarios, while the Barclay's ePayment is excluded from scenarios 6–10. In doing so, the percentage difference between the smaller and larger banks ranges from –1% to 13% across the ten scenarios.
[10] The following brands have been grouped as follows when referring to the largest four in England and Wales: RBS and NatWest, Lloyds and Bank of Scotland, HSBC and Barclays. The banks which have been grouped to form the biggest three in Scotland are: RBS and NatWest, Lloyds and Bank of Scotland and Clydesdale.
[11] The weightings are based on the number of active BCAs as a proportionate split of customers across the different tariffs offered by the bank.
[12] The Barclays ePayment and RBS Business Banking Direct tariffs may be seen as 'outliers' which influence the average of the largest four banks, where the RBS Business Banking Direct Tariff is excluded from all scenarios, while the Barclays ePayment is excluded from scenarios 6–10. In doing so, the percentage difference between the smaller and larger banks ranges from 9 to 23%.

TABLE 3 **Comparison of the tariff offerings of the largest four banks and Clydesdale and the smaller banks**

	SME transactional profile									
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
Average smaller banks (£)	8.93	10.05	12.24	13.15	20.73	16.51	28.05	40.60	51.65	64.24
Average smaller banks (excl Santander) (£)	9.45	10.66	13.09	14.07	22.49	17.41	29.60	44.04	54.81	69.28
Average big 4 banks & Clydesdale (£)	10.98	12.15	14.95	16.16	25.81	19.70	35.24	52.56	66.33	84.35
% big 4 banks & Clydesdale are more expensive on average	23	21	22	23	24	19	26	29	28	31
Weighted average big 4 banks & Clydesdale (£)	10.70	12.11	15.29	16.65	27.31	20.94	36.19	53.52	67.60	84.69
% big 4 banks are more expensive on average	20	21	25	27	32	27	29	32	31	32

Source: CMA/FCA analysis of *Business Moneyfacts*.

11. However, we recognise that there are a number of limitations to this type of analysis:

- A particular tariff may be relatively expensive for an SME with a particular transaction pattern but would not be so for an SME with a different transaction pattern. We have tried to deal with this by considering ten different scenarios. This causes some tariffs to be relatively expensive for some transaction profiles but relatively cheap for other transaction profiles. However, these scenarios are not comprehensive and may not reflect the most frequent customer profiles for the customers on that type of BCA. This may be particularly the case given that the customer profiles have been derived from the customer base of one bank.

- The analysis does not consider certain elements of BCA pricing. It does not consider all the types of charges that may be incurred through transactions on a BCA. Rather, it focuses on the most commonly-used transactions, which all relate to money transmission. The analysis also does not consider interest paid on credit balances, nor interest and charges charged on overdrafts. It could be that a particular BCA tariff which appears highly-priced in the scenarios in our analysis would not be highly-priced for some SMEs when assumptions are made about their credit and debit balances.

- The analysis does not consider negotiated terms. As shown in Chapter 7, bespoke terms are not uncommon for BCAs, but are usually only offered to larger SMEs.

- Some banks offer tariffs which provide lower prices for SMEs using direct (Internet/mobile) banking channels and offer other tariffs designed for SMEs which are likely to use branches more often. We wish to compare available tariffs across all ten transaction profiles. However, we recognise that it may not be appropriate to compare the costs of tariffs designed for direct channels against those designed for branch use. However, it is often not clear how, or if, we should separate certain accounts in the composition. In addition, banks may not always offer different accounts based on this segmentation, as some banks may offer only a single BCA regardless of the preferred channel usage of an SME.

- The average pricing, which is calculated below, is for the largest four banks Great Britain wide by market share or by the largest four banks in England and Wales, and largest three in Scotland, and is not as we have defined the markets in the market study. However, as the tariff pricing which is set by banks is on a Great Britain basis, we have found little differentiation between England and Wales, and Scotland.[13]

- For some scenarios, the comparison of the largest four banks in the UK or the largest four banks in England and Wales, and largest three in Scotland, versus 'smaller' banks are strongly influenced by certain banks' tariffs. In particular, if Santander was considered as one of the larger banks in either England and Wales or the UK, then there would be much less difference between the larger and smaller banks pricing.

- With regard to the weightings used in the calculations above, we have assumed an equal weighting for the two tariffs which are offered by Clydesdale.[14]

- Lastly, this analysis does not consider variations in quality of service.

Addendum methodology for the analysis of BCA pricing

12. This addendum provides greater detail on the tariff analysis. It sets out the following:

    - details of the transaction profiles we have used for the tariff analysis

    - details of the tariffs and how the banks compare in terms of their tariffs across the ten different transaction profiles we have used

13. Banks may offer multiple BCAs. A number of these offerings may be aimed at branch users or at customers who access the bank through electronic channels.[15] BCAs which have specific terms and conditions (such as promotional offerings like Santander's 'free banking for life') or are aimed at a particular type of business (for example, clubs and societies) are excluded

[13] One such exception to this is RBS's BCA, which offers different tariffs to Scottish customers.
[14] It should be noted that if weightings of 90/10% or 10/90% are used, then the average for the biggest banks is likely to vary between 4 and 8% depending on the scenario.
[15] This is evident when looking at MoneyFacts, which distinguishes between BCAs for online and branch users.

from this analysis. Furthermore, many BCAs have turnover restrictions and are therefore not available to SMEs across the board. In addition:

- tariffs offered by banks change over time (and SMEs may be on legacy tariffs which have not been included in this analysis)[16]
- some BCAs offer loyalty discounts to SMEs (eg Barclays ePayments BCA)
- other tariffs may vary by region (eg RBS standard tariff has separate prices for England and Wales, and Scotland)
- some BCAs incur no charge if the credit balance is above a specified limit (eg Metro levies no transaction charges when an SME has a credit balance of £5,000)

14. In addition, even when banks offer more than one BCA and segment their BCA by channel usage, they may not restrict which accounts can be used by which SMEs. Consequently, an inappropriate tariff would incur additional banking expenses to an SME. Only [✂] provides a guarantee to ensure that its customers are on the most appropriate tariff for their needs.

15. The different scenarios as identified by one bank for its internal pricing analysis are as follows: [✂].

16. For each of these customer profiles, the bank constructed the transactional behaviour shown in Table 4 below. The cost to an SME for each bank is constructed by applying the usage patterns below to the tariffs which are applicable for a given scenario.

TABLE 4 **SME transactional profiles**

					Scenario					
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: Bank data.

17. For the above transaction analysis, the following tariffs were used for scenarios 1 to 10:

- *Bigger banks:* Barclays Business Free Automated Transactions Tariff, Barclays Business Credit Interest Tariff, Barclays ePayments, Barclays Mixed Payments, Lloyds Electronic Business, Lloyds Business Extra,

[16] The Barclays FAT and Credit Interest tariffs have been included in the analysis [✂].

Lloyds Monthly Price Plan, Bank of Scotland Electronic Business Tariff, Bank of Scotland Business Extra Tariff, HSBC Small Business Tariff, RBS Business Current Account, NatWest Business Current Account, RBS Business Plus, NatWest Business Plus, RBS Business Banking Direct

- *Smaller banks:* Allied Irish Business Plus (GB), Bank of Ireland Business Current (GB), Metro Business Bank Account, Santander Business Current Account, Co-Op Cash Tariff, Co-Op Business Direct Plus, Co-Op BCA: Standard Tariff, Yorkshire Bank Business Choice

18. The following tariffs were used:

- NatWest Advantage Business and Santander Client Business Account were included as tariffs for the bigger banks in scenarios 1 to 5
- HSBC Electronic Banking Tariff was included as a tariff for the bigger banks in scenarios 1 to 7 and 9
- The TSB Electronic Business Tariff, TSB Business Extra Tariff and TSB Fixed Fee Plan were included as tariffs for the smaller banks in scenarios 1 to 7 and 9
- The Clydesdale Current Account and Clydesdale Business Choice tariffs were included as part of the bigger banks tariffs only when comparisons were made using the biggest three banks in Scotland and biggest four banks in England and Wales, That is, where comparisons were made with the largest four banks in the UK by market share, these tariffs were classed with the smaller banks.

19. Many banks will often have a number of tariffs. In calculating the average for the smaller and the bigger four banks, we have taken a simple average across the relevant banks. The banks also provided the number of active current accounts at the end of 2013. A proportionate split of customers across the tariffs which were used in this analysis was therefore calculated and used to determine a weighted average.[17]

[17] Tariffs which were not used in the tariff comparison were therefore excluded when determining the proportionate split of customers across the tariffs used in the analysis.

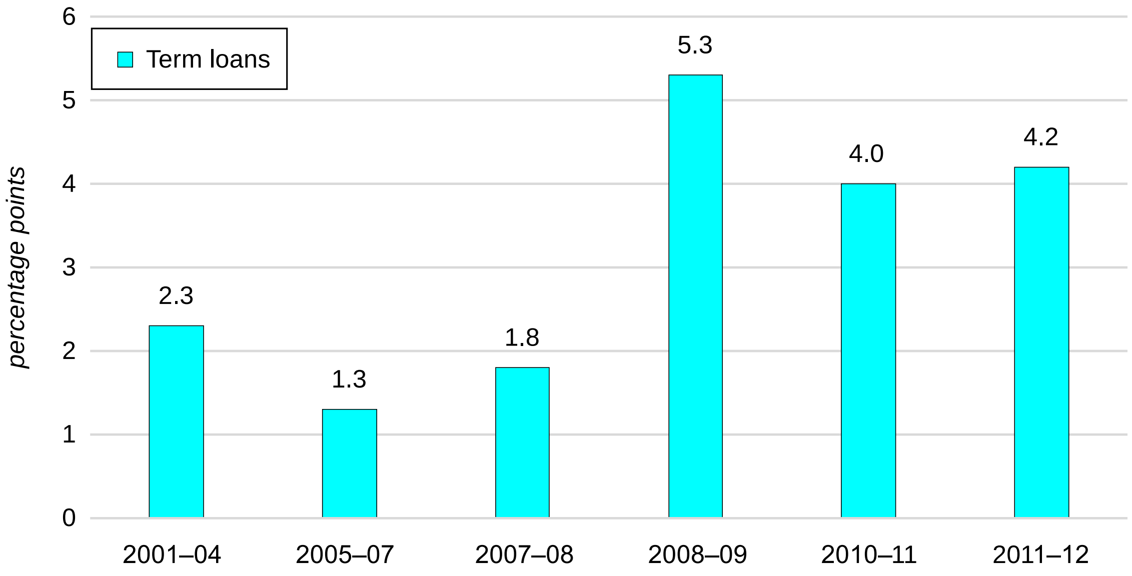
Prices for business lending

1. In this annex we set out our findings on pricing for business lending products.

2. First, recent analysis conducted by the National Institute of Economic and Social Research (NIESR) indicates that there has been a widening of the difference between base rates and lending rates since 2007. In particular, the NIESR 'margins for term loans were … significantly higher in the period from 2008-9 onwards, even controlling for risk, as cuts in the Bank of England base rate were not fully transferred on to SME borrowers'.[1] These changes in differences for term loans are shown in Figure 1 below.[2]

FIGURE 1

Differences between interest rates and the base rates for term loans, 2001 to 2012



Source: Chart 4, NIESR (2013).

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[1] Armstrong et al, 'Evaluating changes in bank lending to UK SMEs over 2001-2012 – ongoing tight credit?' NIESR Discussion Paper No 408, February 2013 ((NIESR (2013)). The analysis also found that there had not been significant increases since 2008/09 in the need to provide collateral, and that arrangement fees have returned to their pre-2008 levels following a spike in 2008/09.
[2] See Chart 4 from NIESR (2013). The differences are calculated as a difference between interest rates charged and loans/overdrafts and Bank of England bank rate at the time of an interview with an SME. The interview data comes from the SME Finance Monitor 2010–2012, as well as similar surveys which preceded this. The pattern of differences may be affected by the composition of borrowers over time. However, the econometric analysis in the paper also finds that, when controlling for firm characteristics, differences fell in 2005–07 relative to 2001–04, but differences were much higher in the periods following 2008.

3. However, as the authors of the report themselves acknowledge, the overall pattern in Figure 1 may be affected by changes in the composition of borrowers over time.[3] They also recognise that bank funding costs can be quite different from the Bank of England base rate.[4]

4. The authors conclude that such rates, in combination with higher rejection rates for loan applications, indicate a shortage of finance to SMEs which they explain reflect 'banks' attitudes to risk and their own pressures to deliver combined with banks' market power in the SME sector'.[5] While bank market power was therefore considered in the analysis, it was not able to be dis-aggregated from the banks' overall attitude to risk.

5. A more recent report, the Large Review, also looked at the degree to which changes in base rates have been passed on to customers, but uses different sources of data.[6] The Large Review also differs from the NIESR report in that it does not econometrically control for customer risk but it does consider costs of funding to the bank other than Bank of England base rates, and how these may have changed over time. It found that 'between 2000 and 2007, the interest rate charged by the banks generated a return on capital broadly in line with the hurdle rate expected by shareholders, given the regulatory capital requirements of the time'.[7]

6. The report also found that, as the Bank of England base rate was reduced from 2007, differences between bank interest rates and base rates increased from around 2% in 2007 to 3% in 2011.[8] However, the analysis suggests that the financial crisis also had a major impact on the banks' incremental funding costs for the same period, which increased from less than 0.5% to around 3.5%, while the overall cost of capital for the banks also increased, from around 1% to 2%, due to more demanding regulatory requirements. The

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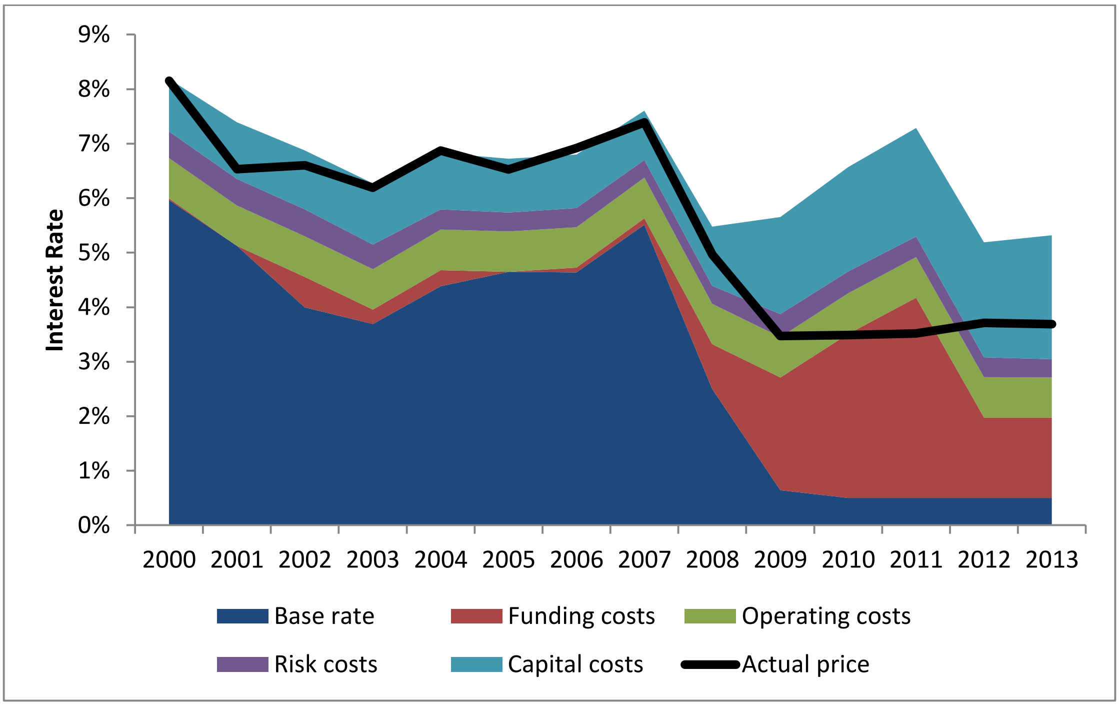
[3] NIESR (2013), p16.
[4] However, the authors also argue that 'the higher funding costs are likely to reflect uncertainty and concern over the conditions of the banks and to this extent are reflected in the spread as a cost transferred to borrowers rather than absorbed by banks' (p15).
[5] NIESR (2013), p52.
[6] Large Review, pp19–23. This report uses interest rate data from the Bank of England's *Trends in Lending* (rather than the survey evidence used in NIESR (2013)). The price of lending is measured by the Bank of England as the industry median price at which new variable rate loan facilities were originated, which is shown in Figure 2 as the full price paid by the customer (ie the base rate plus the interest rate margin charged by the bank).
[7] Large Review, pp19–23. The hurdle rate is the expectation of the return that investors will make, or investors' minimum required return, on the capital they provide to the bank by investing in the bank's equity. In its 2002 report, the CC found that the main clearing banks in England and Wales were securing a return greater than their costs of capital for the period covered in their profitability analysis (1998–2000). The OFT has not tested the methodology in the Large Review.
[8] Large Review, pp19–23.

changes in the various components of the costs of lending, and the median price of lending, are shown in Figure 2.

FIGURE 2

Average economics of UK SME lending for banks, 2000 to 2013*



Source: Large Review, Figure 7, p22.
*Actual price is measured by the Bank of England as the industry median price at which new variable rate loan facilities were originated. It is shown here as the full price paid by the customer (ie the base rate plus the interest margin charged by the bank). Source data: Bank of England *Trends in Lending*; Oliver Wyman analysis.

7. From 2011, the costs of bank funding reduced, allowing lending to SMEs to generate a return of approximately 3 to 7%. Although this means that banks appear to be, on average, covering their funding costs, operating costs and risk costs, it also suggests that interest payments on SME loans, as a stand-alone product, are not generating a sufficient return to meet the requirements/expectations of investors.[9]

8. Despite the above findings, there are important limitations to the Oliver Wyman analysis of loan pricing. The median price figure used will not reflect how pricing will vary across SMEs depending on their risk profile, turnover band, sector or region; nor does it reflect how pricing differs between different banks. Similarly, the costs of lending are likely to vary significantly between different banks. This may arise for a variety of reasons, including how they

[9] Large Review, pp19–23.

fund their lending; the internal treasury rules they use for allocating capital;[10] and how much capital they choose to hold to meet regulatory requirements or otherwise. Therefore, the aggregation and averaging in the Oliver Wyman analysis will necessarily not capture certain important variations between providers. It is also important to note that the analysis cited states that ‘charges for other services (such as transaction services) typically mean that banks make a hurdle rate of return on their overall SME banking operations’.[11] Therefore, it is not suggested that SME banking overall is not a profitable endeavour, only that loan pricing appears not to cover hurdle rate returns.

9. Moreover, and in any event, Figure 2 above shows that the median price of lending has been largely constant since 2009, matching the trend for Bank of England base rates. This is despite the significant changes in the amount of capital which banks are required to hold and in their funding costs. Maintaining such an average price, which is increasingly at odds with its marginal cost, would tend to suggest that there may be additional factors other than competition to explain the pricing patterns which we observe. In this regard, it has been suggested to us that the banks, in order to demonstrate a willingness to lend so as to enhance their respective reputations in response to significant public interest in this issue, may be more willing to continue to lend to customers at below economic costs.

[10] The Large Review analysis considers the marginal cost of lending to SMEs. Individual banks may not always look at the marginal cost of lending when deciding how to price their loans. Rather, they may consider the weighted average cost of lending, which could reflect the cheaper source of funding available from deposits which are held with them, or government funding schemes, such as FLS.
[11] Large Review, p23. It is additionally noted that the overall SME banking business, which includes other products such as transaction banking and deposits, generates a return on equity of 10–15% (p31). Further, the analysis of loan pricing does not include asset finance or invoice discounting.