Banking services to small and medium-sized enterprises

A CMA and FCA market study

18 July 2014

The Competition and Markets Authority and Financial Conduct Authority have excluded from this published version of the market study report information which the CMA considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure) and information which the FCA considers should be excluded having regard to the confidentiality requirements in section 348 of the Financial Services and Markets Act 2000. The omissions are indicated by [✂].

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1. Summary

1.1 There are over 4.5 million small and medium-sized enterprises (SMEs) in the UK, accounting for some 60% of private sector employment and almost half of the total turnover of private sector businesses; their success, flexibility and adaptability are crucial to the strength of the UK economy as a whole.

1.2 SME banking is also an important high-value sector in itself. Business current accounts (BCAs) are an indispensable service to the large majority of SMEs and generate well over £2 billion in revenue a year. SME business loan balances are around £90 billion.

1.3 Effective competition to provide SMEs with high-quality and responsive banking services, at the lowest possible cost, is critical in ensuring that SMEs are able to get what they need from their banks. It is to assess whether such effective competition exists in this crucial sector that the Competition and Markets Authority (CMA) and the Financial Conduct Authority (FCA) have worked together on this market study.[1]

1.4 This market study builds on previous reviews undertaken in the SME banking sector. It focuses on core SME banking services, namely liquidity management services (BCAs and overdrafts) and general purpose business loans (business loans). In taking forward this market study, we have been informed by a view as to what a well-functioning sector would look like. In our view, such a well-functioning sector would exhibit the following characteristics:

- **A banking sector which is customer-focused.** Providers' products are well suited to their customers' needs and are provided in a way that makes it easy for customers to make well-informed decisions about how and when they are used.

- **Consumers are sufficiently engaged with their banking services to drive competition.** Banks equip their customers to make better decisions about which products they use, and how they use them.

- **Competition between banks (and from non-banks) is driving providers to operate more efficiently and to innovate.**

- **Consumers have a broad choice of provider.** The sector is relatively less concentrated than it has been historically, and newer and smaller

[1] The question of a market investigation reference (MIR) and the review of undertakings which were given following the Competition Commission (CC) investigation, the report of which was published in 2002, was solely a matter for the CMA and the FCA played no role in either the MIR decision or the review of the undertakings.

banks and/or new technology provide scope for increased competition from outside the traditional banking model.

- **Barriers to entry and expansion are lower.** Credible new players are able to join the market and have reasonable prospects for attracting the scale of customer base needed to achieve the economies of scale required to operate effectively.

1.5 However, during our market study, we have found that the sector does not exhibit many of these characteristics. Indeed, we have found that many of the concerns identified in previous reviews remain:

- The provision of BCAs and business loans is concentrated among the largest four banks, with those providers maintaining relatively stable market shares; indeed, the sector is now as concentrated as it was in 1999

- New entry has been limited and there are still high barriers to entry and expansion for newer and smaller banks

- SME customers believe there to be little differentiation between providers

- SMEs have difficulty comparing offers across providers and demonstrate low levels of shopping around

- The banks with lower customer satisfaction levels have high market shares and are not losing significant market share – while those with the highest customer satisfaction are not able to expand

These issues are closely interlinked, as we explain below.

1.6 Although there have been some welcome developments in recent years, concerns remain that the combination of these factors means that competition is less effective in delivering good outcomes for SMEs, particularly in relation to the service they obtain from their banks, than would be the case in a market where banks are under more competitive pressure.

Background

1.7 Competition in SME banking has been the subject of detailed consideration by the UK competition authorities and other bodies periodically over the last 15 years. This started with Sir Donald Cruickshank's review of retail banking, published in 2000, followed by the CC's investigation of SME banking, published in 2002 (the CC inquiry). The most recent reviews into the retail banking sector (including SME banking) have included the Independent Commission on Banking (ICB), chaired by Sir John Vickers, whose report (the

Vickers review) was published in 2011, and the 2013 report by the Parliamentary Commission on Banking Standards (PCBS).

1.8 These previous reviews have found significant concerns about the effectiveness of competition in SME banking, particularly:

- the persistence of high levels of concentration
- high barriers to entry and expansion
- a relatively weak demand side, with customers not being able readily to access, assess and act on information they would need to ensure that they get the best possible deal

1.9 These concerns led to a recommendation, both in the Vickers review and in the PCBS report, that consideration be given to making an MIR by 2015, if not earlier.

1.10 SME banking has been, and continues to be, subject to a number of important developments which may impact on the above competition concerns, including, among other things:

- divestments from the Lloyds Banking Group and the Royal Bank of Scotland Group to create two additional banks
- changes to the authorisation regime for new banks, making it simpler and faster
- the establishment of the Payment Systems Regulator (PSR) which will become fully operational in April 2015. The PSR's objectives will be to promote competition, innovation and the interests of end-users through overseeing designated UK domestic payment systems
- the introduction of the new seven-day Current Account Switching Service (CASS), which is available to smaller SMEs
- proposed legislation to increase the availability of SME creditworthiness information to help newer or smaller providers to make more effective lending decisions, thereby helping them to compete more effectively with the larger banks
- there has also been significant investment by the banks in service delivery, particularly in mobile and digital technology

1.11 These developments are valuable in addressing some of the historical concerns. Nevertheless, it is clear that fundamental competition concerns remain.

1.12 The SME banking market study is one of a range of projects being undertaken by the CMA and FCA relevant to competition in the retail banking sector. Related work includes: *(a)* an update by the CMA of the Office of Fair Trading's (OFT's) review into personal current accounts (PCAs) and *(b)* the FCA's own market studies into cash savings (the interim findings of which were published on 8 July 2014) and credit cards (which will be launched by the end of the year). It is clear from that related work that many of the competition concerns we discuss in this report (barriers to entry, concentration, a customer base that has difficulty accessing and assessing relevant information and spends little time shopping around) are not unique to SMEs, albeit that SMEs and the core banking products they rely on have some characteristics that justify separate analysis.

The SME banking market study

1.13 In light of the previous investigations of the sector, we have built on and updated the evidence base, taking careful account of the recent developments in the sector. We have also considered what, if any, further steps are needed to improve competition for the core banking products for SMEs, that is BCAs and business loans, which we have focused on during this market study (the focal products) given their wide importance to SMEs.

1.14 During the market study, we have engaged extensively with interested parties from across the UK, including SMEs and their representatives, larger and smaller banks, and other financial service providers. The wide range of views obtained and the evidence considered has been critical to ensuring that our conclusions reflect the wide variety of perspectives about competition in the SME banking sector.

Key findings

1.15 In conducting this market study, we have focused on the following core issues, which have been the fundamental and long-standing areas of competition concern:

- the market structure of the SME banking sector, including, in particular, entry and expansion into the SME banking sector

- SMEs' behaviour as customers in the market, particularly the extent of shopping around, switching and negotiation

1.16 These issues, which are examined individually below, are linked and need to be considered in combination in order to reach a fuller understanding of the dynamics of the sector and the effectiveness of competition within it. In completing our analysis we have been very aware of the wide diversity of SMEs and their financial needs. Where appropriate, we have highlighted where there are variances in features or the intensity of competition between different SME customer groups.

1.17 The detailed evidence base in support of the findings summarised below is set out in the remainder of the report.

Key facts and findings:

- The supply of BCAs remains concentrated – 85% of BCAs in England and Wales are provided by the largest four providers, with the sectors in Scotland and Northern Ireland being even more concentrated. This is very similar to the position in 1999.
- The supply of business loans also remains concentrated – almost 90% by volume are provided by the largest providers in each of England and Wales, Scotland and Northern Ireland. Again, this is very similar to the position in 1999.
- Almost 60% of BCA customers at the four largest UK banks also have a PCA with the same bank, indicating the importance of the linkage between BCAs and PCAs. A strong propensity for start-up businesses to choose their BCA provider, based on where they hold their PCA, gives the larger banks an advantage over smaller stand-alone business bank providers and those lacking a strong presence in PCAs.
- Although there has been recent entry into some specialist niches, only one new BCA provider (Metro Bank) has entered the market in recent years.
- There have been important initiatives in relation to improving access to information on creditworthiness and new bank authorisation which are likely to reduce some barriers to entry and expansion.
- However, significant barriers to entry and expansion remain: despite substantially increased usage of online and mobile banking, and reduced usage of branches, branches are still valued by most SMEs, so that a network of local branches still seems necessary to be a significant competitor in the sector; and concerns have been expressed to us about the cost and difficulty for smaller and newer banks to gain access to payment systems which are key to offering BCAs.
- As new entry or potential new entry is one of the key competitive constraints encouraging existing providers to compete on price, service and innovation, such barriers result in a reduced incentive on the largest banks to compete.
- The situation is made worse by low switching rates and customer inertia (set out in more detail below), with the result that there are insufficient numbers of profitable customers that are sufficiently easy for smaller and newer providers to acquire.

1.18 There is no simple relationship between concentration and competition. However, more concentrated markets are in some cases less competitive. This is more likely to be the case where barriers to entry and expansion are significant.

1.19 We have found, in relation to each of the focal products, that high levels of concentration persist, with few changes in the market shares of providers since 1999. Where changes have occurred, these have tended to follow merger activity, rather than through organic growth by providers.

1.20 We have seen some encouraging signs of new entry (eg Metro Bank) and expansion (eg Aldermore, Shawbrook and Handelsbanken). However, this entry and expansion has tended to be very small scale in nature or focused on niche products, such as specialist lending, or on specific customer groups, such as larger SMEs. These providers do not appear to exercise a more general competitive constraint on the largest banks.

1.21 We have also seen evidence of a number of encouraging developments which mean that barriers to entry or expansion are decreasing, or are likely to do so into the future. These include those initiatives referred to above, among others, as well as continuing technological developments, such as the emergence of lower-cost, so-called ‘bank in the box’ IT systems for new entrants.

1.22 However, despite these developments, and consistent with the views expressed to us by various smaller providers during the market study, high barriers to entry and expansion remain, particularly:

- a result of limited shopping around and switching by SME customers is that new entrants and smaller providers find it difficult to acquire sufficient volumes of profitable customers and expand market share
- the need for a wide, costly local branch network to be an effective competitor, something that continues to be of significant importance to SMEs, despite the growing importance of online and mobile banking
- concerns about the actual or believed difficulties and costs associated with gaining access to payments systems, which are vital to being able to offer BCAs
- capital requirements, which appear to have a greater effect on smaller and newer banks than on established banks

1.23 These barriers continue to restrict the ability of smaller and newer providers to grow and develop their SME business in competition with the largest banks.

1.24 One feature of the SME banking market is that there are always large numbers of businesses being established while others are ceasing to trade. This, along with limited bank switching, leads to a high rate of ‘churn’ for BCAs. The large banks have argued that the effect of having to acquire significant volumes of customers each year forces banks to compete particularly intensely for new customers in order to maintain market share.

1.25 We recognise that, despite the levels of concentration we observe, the high rate of churn in this market could lead to providers having to compete more intensely for new business customers to avoid losing market share over time. However, despite more intense competition for new customers and switchers, we believe that the larger incumbents continue to enjoy certain advantages which mean that competition is not sufficiently effective even for these customers. In particular, we have found that most SMEs (especially the smaller SMEs) choose, initially at least, to obtain a BCA from their PCA provider, providing the largest providers with a 'first port of call' advantage. They then are likely to take other products from that provider, particularly lending products. A provider is, therefore, less likely to capture new-to-market SMEs, and then to be able to cross-sell to them a range of products, if it does not currently provide their PCA. This limits the growth potential of stand-alone business bank providers or banks lacking a strong presence in the PCA market which, as we see in the accompanying market study into PCAs, is also a concentrated market.

1.26 However, as we explain below, we recognise that this concentrated market structure may be caused to a certain extent by SME customer inertia, rather than being, in itself, a factor restricting competition. Moreover, as we describe below, it is the combination of concentration with other features in this market which, in our assessment, particularly hinders competition.

SMEs’ behaviour as customers in the market

Key facts and findings:

- Only 4% of SMEs switched provider last year – this proportion has been substantially unchanged for a decade and does not vary by size of SME. This is lower than the figures for telecommunications and energy.
- SME take-up of the new seven-day CASS is low: only 7,330 SMEs switched using the CASS in the six months to March 2014 – a very small proportion given that there are over 3.5 million BCA holders, the very large majority of whom are covered by the CASS.
- Fewer than 25% of SMEs shop around for BCAs (albeit larger SMEs shop around more). Almost 60% of SMEs spend less than an hour researching providers of lending.
- Around 10% to 20% of SMEs rated the overall standard of service they received from their main banks as poor. Despite this level of dissatisfaction, the annual switching rate remains at 4%.
- A key factor in these low rates of shopping around seems to be the strong belief among SMEs that ‘all banks are the same’ – over 70% consider that there are no better or only marginally better BCA providers compared to their current provider.
- Around 70% of SMEs seeking loans approach only one provider, without considering alternatives; almost 90% then take out that loan with their main bank.
- There is low SME awareness of alternatives – fewer than 25% of SMEs are aware of peer-to-peer finance, for example, although awareness of these alternatives is greater for larger SMEs.
- The pricing of BCAs and loans appear complex. For both BCAs and loans, it can be difficult for SMEs to get a detailed understanding of the cost of using these products.
- SMEs find it difficult to compare prices between providers and even more difficult to distinguish differences in service quality. Overall, challenges remain for SMEs who wish to evaluate their current provider against potential alternatives in the market.

1.27 In general, the more switching that takes place between providers, the stronger are providers’ incentives to compete to retain and win customers which, in turn, drives better offers for customers. However, switching is not the only way in which SMEs can drive competition; they may shop around, and decide not to switch, or they might instead negotiate over price and elements of the service offered.

1.28 However, despite recent improvements, such as the introduction of the CASS and improvements in transparency (particularly the greater transparency over service levels created by the recent Business Banking Insight website), the evidence shows that SME engagement levels (particularly for the smaller SMEs) remain low. We believe that this low level of engagement reflects significant barriers to them accessing, assessing and acting on information to help them ensure that they get the best deal and drive competition between providers, and SME inertia:

- Very few SMEs shop around, which reflects a strong belief that there is limited differentiation between the offers available at different banks, and levels of switching remain relatively low.
- While we have seen evidence of some negotiation, we have found that there are relatively few SMEs that are likely to be able to negotiate successfully with providers to secure a competitive deal. Those that do tend to be the largest SMEs, which represent only a small minority of SMEs. Most SMEs are in fact sole traders and micro-enterprises which demonstrate a similar lack of financial literacy and bargaining power to individual customers when purchasing financial products.
- BCA and loan pricing remains highly complex, with limited information available to SMEs which makes it difficult for SMEs to make effective comparisons across providers.

1.29 We consider that this low SME engagement continues to be a significant feature of this sector, substantially reducing providers' incentives to compete. However, competition is likely to be greater for those larger SMEs which are more engaged and better able to negotiate with their banks.

The interaction between these features

1.30 Our analysis is that the features above are closely interrelated and mutually reinforce one another, resulting in competition being more limited than it would otherwise be. In particular, SME inertia weakens competitive constraints by reducing provider incentives to compete. It also creates significant barriers for other providers to enter the sector, by significantly reducing the number of profitable customers available for smaller and newer providers to grow and develop their business. Customers' belief that there is limited differentiation between providers, which may result from the relatively limited available choice of larger providers, each with a similar business model, results in SME inertia. This in turn means that there is no countervailing pressure on providers to improve offers to SMEs and differentiate themselves from the competition.To address these concerns, changes may therefore be necessary on the demand side (SME customer behaviour), on the supply side (to the market structure), or both.

1.31 This dynamic is illustrated below.

Customer outcomes for SMEs

Key facts:

- Only 13% of SMEs trust their bank to act in their best interests.
- Only 25% of SMEs consider that their bank supports their business.
- While levels of dissatisfaction are low (10%), they are much higher than the annual rate of switching (4%).
- Levels of satisfaction are also limited – satisfaction scores are around 60% for BCAs. Satisfaction is lower than for companies in other sectors such as telecommunications and energy. However, larger SMEs tend to be more satisfied with their bank.
- Across the sector as a whole, there is a net promoter score of *minus* 8%, indicating that more SMEs would be unwilling to recommend their bank to a friend than would be willing to do so. Smaller banks, however, tend to have higher net promoter scores.

1.32 We have been told by both SMEs and banks alike that most SMEs are more concerned with the service that they obtain from their bank, rather than the prices charged, making service the key dimension of competition for most SMEs. Consistent with our findings about the state of competition in the sector, we consider that there is considerable room for improvement in the service which SMEs receive from their banks:

- Satisfaction levels are relatively low, with particular concerns about the quality of relationship management services
- Few SMEs trust their banks to act in their best interests and few feel supported by them
- Most SMEs would be unwilling to recommend their banks

These outcomes do not suggest that the market is effectively delivering the service that SMEs want or need, although we also recognise that service and satisfaction levels for the largest SMEs are relatively higher than they are for smaller SMEs.

1.33 Although we have also carefully considered prices for the focal products, given the complexities associated with pricing structures in the sector, we have not sought, in this first-stage analysis, to draw definitive conclusions on pricing outcomes for SMEs.

Conclusions

1.34 In our assessment, while there have been some important improvements in recent years, this sector remains characterised by a number of features which, particularly when taken together, appear to result in a sector in which a believed lack of choice of providers combines with, and reinforces, SME inertia, apparently resulting in suboptimal outcomes for SMEs. In particular, we note that the providers with the highest customer satisfaction scores are not winning significant market share, while the banks with the lowest satisfaction rates are barely losing market share – which are not the outcomes we would expect in a well-functioning, competitive and dynamic market.

1.35 As a result of these findings, the CMA has assessed whether it would be appropriate to make an MIR, based on the statutory test in section 131 of the Enterprise Act 2002 and on the published criteria for the CMA deciding whether to exercise its discretion to make an MIR. Following that assessment, and for the reasons set out in the accompanying provisional decision regarding an MIR, the CMA has provisionally decided to make an MIR in relation to aspects of the retail banking sector, including SME banking. The CMA is now consulting on that provisional decision and will make a final decision as to whether to make an MIR in the autumn of 2014.

The undertakings given in 2002/03

1.36 Following the CC inquiry, the major banks gave undertakings to improve transparency, facilitate switching and restrict bundling of products in SME banking. We have reviewed these undertakings alongside this study to assess whether there has been a change of circumstances since they were implemented which means that they should now be reviewed.

Whether to consider varying or removing the undertakings

1.37 We have found that concerns in relation to switching and transparency remain, and consequently, we do not consider there to be a realistic prospect of a change in circumstances relevant to the majority of the undertakings, such that they should be varied or removed.

1.38 However, we note the improvements to the switching process from the CASS, which applies to SMEs with a turnover of up to €2 million. While the CASS has not fully addressed concerns in relation to switching, we consider that it is a more effective mechanism for doing so in relation to smaller SMEs than the current switching undertakings. We therefore consider there to be a realistic prospect that the CASS represents a change in circumstances that may mean the switching undertakings are no longer appropriate as far as they relate to smaller SMEs. For SMEs that are too large to use the CASS, we have not identified a realistic prospect of a change in circumstances. We now invite comments from parties as to whether a review to vary the undertakings should be a priority for the CMA.

Compliance with the undertakings

1.39 In relation to compliance with the undertakings, the OFT monitored these undertakings since 2002, including conducting a full-scale review of them in 2007. Following more recent concerns about compliance with the bundling aspects of the undertakings, the OFT agreed with each of the banks subject to the undertakings that they would conduct an annual review of compliance, with the first report due by 11 July 2014; and that each bank would provide an annual written reminder to relevant staff to ensure that they are aware of the bundling undertakings and the seriousness with which they are treated by the bank. The CMA will make a further announcement concerning compliance with the undertakings once it has completed its review of the recently received audit reports from the banks that are subject to the undertakings.

2. Introduction

2.1 SMEs play a critical role in the UK economy, accounting for some 99.9% of all private sector business by number, almost 60% of private sector employment and almost 50% of private sector turnover.[2] Their success, flexibility and adaptability are crucial to the strength of the UK economy as a whole.

2.2 Effective competition to provide SMEs with high-quality and responsive banking services, at the lowest possible cost, is critical in ensuring that SMEs are able to get what they need from their banks. It is to assess whether such effective competition exists in this crucial sector that the CMA and the FCA have worked together on this market study.[3]

2.3 In this introductory chapter, we first set out the background to this market study, before discussing the approach we have used in conducting it.

The market study and the roles of the OFT, the CMA and the FCA

The market study

2.4 This market study represents the first example of collaboration between the OFT, the CMA and the FCA. We have worked in close collaboration as envisaged by the FCA–OFT memorandum of understanding (MoU).[4]

2.5 This market study was launched by the OFT on 19 June 2013. On 11 March 2014, the OFT and the CMA announced that, in the light of changes to the competition regime in the UK, responsibility for completion of the market study would pass from the OFT to the CMA.[5] The CMA works to promote competition for the benefit of consumers, both within and outside the UK, and aims to make markets work well for consumers, businesses and the economy.

2.6 As well as forming part of the CMA's wider work programme in banking, the SME banking market study also forms part of the FCA's competition programme, which includes, in addition, the FCA's own market studies into cash savings,[6] retirement income and general insurance add-ons. The FCA has an operational objective to promote effective competition in the interests of consumers. It also has a duty to promote effective competition when using its general functions to advance its consumer protection and market integrity

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[2] See FSB website.
[3] The question of an MIR and the review of undertakings which were given following the CC's investigation, the report of which was published in 2002, was solely a matter for the CMA and the FCA played no role in either the MIR decision or the review of the undertakings.
[4] Published 2 April 2013
[5] See our website for copies of these announcements.
[6] The interim findings of the Cash savings market study were published by the FCA in July 2014. Further details can be found on the FCA website.

objectives. Together, the objective and the duty provide the FCA with a strong mandate to help the organisation achieve its strategic objective of making markets for financial services work well.

2.7 An activity is a regulated activity for the purposes of the Financial Services and Markets Act 2000 if it is specified in the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001. Examples of regulated activites within the scope of this study include the provision of BCAs. With the exception of small business loans covered by mortgage or consumer credit regulation, lending to businesses, including SMEs, is not an activity regulated by the FCA.[7] While SME lending falls outside the FCA's regulatory perimeter, the FCA considers competition in financial services offered to SMEs, as well as other customers, to be essential. As the FCA develops its competition work more generally, it intends to take account of SMEs as a distinct subset of consumers when designing thematic work. It also intends to develop a communication and education strategy to increase SME understanding of potential detriment and awareness of sources of financial advice.

2.8 The market study report represents the joint findings and recommendations of both the CMA and FCA.[8]

2.9 The FCA is expected to be granted concurrent competition law powers with effect from 1 April 2015.[9] This will include the power to apply the Competition Act 1998 and to make MIRs pursuant to the Enterprise Act 2002. Until these powers take effect, the FCA does not have jurisdiction to make an MIR. The consultation document in relation to an MIR, which accompanies this market study, is therefore issued by the CMA alone and is published separately from this market study report.

The behavioural undertakings

2.10 Given their direct relevance to the issues considered in this market study, the CMA has conducted a preliminary assessment of the behavioural undertakings (the Undertakings) given by each of the major clearing banks

[7] From 1 April 2014 the FCA became responsible for consumer credit regulation. Lending money to borrowers, offering goods or services on credit or engaging in specified ancillary credit activities are now activities regulated by the FCA. In addition to consumers, this includes lending to sole traders and small partnerships, but only up to £25,000.

[8] During the course of the market study the FCA had two full-time employees working with the CMA team. Irrespective of whether some of the products fall outside the FCA's regulatory perimeter, the market study report represents the joint findings and recommendations of both the CMA and the FCA. These findings were: *(a)* arrived at under the oversight of a Steering Committee, which comprised senior officials from both organisations; and *(b)* subject to the approval of each organisation's governance process.

[9] The Payment Systems Regulator, which is a subsidiary of the FCA, has concurrent powers in relation to Part 4 of the Enterprise Act 2002 as of 1 April 2014.

following the CC inquiry.[10] We include further information about the CC's inquiry and the Undertakings below.

2.11 The purpose of the CMA's preliminary assessment in this document has been to consider whether the Undertakings continue to remain appropriate or whether, given changes of circumstances in the market since 2002, they should be subject to a review by the CMA which would consider the variation or termination of the Undertakings.[11]

2.12 Consistent with the applicable legal regime, the preliminary assessment of the Undertakings and its conclusions represent the findings of the CMA alone, rather than a joint conclusion by the CMA and FCA.[12]

The CMA programme of work into banking

2.13 Alongside the market study, the CMA has conducted an update of the OFT's 2013 review of PCAs. The decision to undertake these two projects in parallel reflected important linkages between competition issues for PCA customers and for SME customers, in particular:

- the banking providers operating in the sector
- how dynamics of competition operate
- the way that personal and SME customers consume banking services, including levels of customer engagement with banking providers[13]

2.14 The CMA received valuable insights from the FCA relevant to the PCA sector. However, unlike the SME banking market study, which has been a formal collaboration with the FCA since it was first scoped in September 2013, this report is solely a CMA output reflecting the fact that it is intended as an update of the market review published in January 2013 by the CMA's predecessor body, the OFT.

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[10] *A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK*, CC, March 2002 (CC (2002)).
[11] The CMA's process for reviews of undertakings and orders is set out in *Remedies: Guidance on the CMA's approach to the variation and termination of merger, monopoly and market undertakings and orders (CMA11)*. This document serves as an invitation to comment on whether the CMA should conduct a review. This overall process differs slightly from the previous position set out in Chapter 4 of the OFT's scoping paper on SME banking to reflect the abolition of the OFT and the CC and the creation of the CMA.
[12] This reflects the fact that the power to conduct reviews of monopoly undertakings, such as the Undertakings, are for the CMA alone.
[13] See CMA press release.

Background

Aspects of retail banking

2.15 On 19 June 2013 the OFT announced that it would complete a market study on competition in banking services for SMEs, using its powers under section 5 of the Enterprise Act 2002. The market study formed part of the OFT's planned programme of work on retail banking.

2.16 For a number of years the OFT had concerns that competition in the retail banking sector generally was not working well. An OFT review of barriers to entry and expansion and interventions in markets such as PCAs and cash ISAs have found there to be long-standing problems, particularly concerning:

- high levels of concentration in banking markets
- the existence of significant barriers to entry and expansion
- low rates of shopping around and limited switching, often linked to low levels of transparency in the sector[14]

SME banking

2.17 In addition to competition concerns about retail banking generally, long-standing concerns have been raised about the effectiveness of competition in SME banking, dating back to the report of Sir Donald Cruickshank in 2000 through to the Parliamentary Commission on Banking Standards in 2013. We consider the key findings and outcomes of these reports below.

2.18 In March 2000, Sir Donald Cruickshank reported on competition in UK banking (the Cruickshank report). In relation to SMEs, the Cruickshank report concluded that the markets for small business banking services lacked effective competition. It concluded that there was little prospect of effective competition emerging without significant regulatory intervention.[15]

2.19 Subsequent to the Cruickshank report, the CC reviewed the supply of banking services to SMEs in 2002 following a reference from the Secretary of State for Trade and Industry and the Chancellor of the Exchequer (the CC inquiry). The CC inquiry found the supply of banking services to SMEs to be highly concentrated, with the largest clearing banks accounting for over 90% of

[14] See further details of the OFT's work in relation to retail banking.
[15] *Competition in UK Banking,* March 2000.

liquidity management services in England and Wales, Scotland and Northern Ireland. It found that customers showed an unwillingness to switch due to the:

- perceived complexity of switching for little benefit
- importance of a relationship with a bank and bank manager
- banks requiring customers to have a BCA as a condition of receiving other services
- limited degree of price sensitivity by customers
- lack of transparency around pricing

2.20 Moreover, the CC identified the following practices and features as restricting and/or distorting competition:

- similarity of pricing between the major banks (for example, no payment of interest on current accounts)
- differential pricing to customers with free banking being confined only to some SMEs (mostly start-ups and, to a lesser extent, switchers), and the use of selective negotiation to reduce prices for those considering switching
- barriers to entry (including branch infrastructure)

2.21 The CC found that, as a result of the practices and features outlined above, the four largest clearing banks were charging excessive prices and made excessive profits from SME customers in England and Wales.

2.22 To address the features and practices described above, the banks entered into two sets of legally binding undertakings (the Undertakings) to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry, which were implemented between 2002 and 2003. In summary these were:

- the **Transitional Undertakings,** which were designed to remedy the excessive profits and prices of the largest four banks in England and Wales[16] by requiring them to offer free banking services or to pay interest on BCAs

[16] In this market study, where we refer to the largest four banks in either England and Wales or Great Britain, we are referring to Barclays, HSBC, Lloyds Banking Group (Lloyds) and Royal Bank of Scotland Group (RBSG).

- the **Behavioural Undertakings,** which were designed to facilitate competition by reducing switching costs, improving price transparency and placing certain limits on the 'tying' of BCAs with other banking services provided to SME customers[17]

2.23 Following the OFT's 2007 review of the Undertakings (OFT (2007)), the CC decided to release the four largest banks from almost all of the Transitional Undertakings, reflecting the improvements that had been observed in the market since 2002, particularly the expansion of various 'challenger banks', including Alliance & Leicester and the Bank of Scotland. The Behavioural Undertakings, however, were retained in place.[18]

2.24 The OFT subsequently considered barriers to entry and expansion across the retail banking market, including SME banking. It concluded that the greatest barriers came from the difficulty in attracting personal and SME customers due to their preference for banks with an extensive branch network, strong brand loyalty and low switching rates.[19]

2.25 In 2010, the Chancellor of the Exchequer appointed Sir John Vickers to chair the ICB (the Vickers review) in order to consider a number of aspects of the banking sector. After an extensive review of the sector, the ICB report was published in 2011. It found various competition issues in UK retail banking. On the supply side, core markets are concentrated – the largest four banks account for 77% of PCAs and 85% of SME BCAs. On the demand side, competition between banks on current accounts is muted by difficulties of switching between providers and by a lack of transparency about banking services on offer. It considered that, by 2015, an MIR should be considered if the OFT had not already made one.[20]

2.26 The PCBS subsequently considered the operation of the banking sector and published its report in 2013. It concluded that the UK retail market (including SME banking) lacked diversity and this had served to reduce both competition and choice to the obvious detriment of consumers. It also referred to the difficulties associated with switching accounts. With respect to an MIR, it recommended that the CMA immediately commence a market study of the retail and SME banking sector, to ensure that the market study is completed on a timetable consistent with making an MIR, should that be considered necessary, before the end of 2015.[21]

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[17] See the undertakings as they remain in force.
[18] See the OFT's advice following OFT (2007) and the CC's final decision on the undertakings.
[19] OFT (2010) Barriers to entry.
[20] ICB (2011), Final Report. The competition analysis and conclusions can be found at Part 2 of that report.
[21] PCBS (2013).

2.27 The Financial Services Authority (FSA) and the Bank of England conducted a review of barriers to entry in retail banking in 2013 with a view to ensuring that the prudential and capital requirements to enter the sector were necessary and proportionate. As a result of that review, the FCA and PRA agreed a number of specific steps to reduce barriers to entry in the sector:

- reduced capital requirements at authorisation
- removal of the new bank liquidity premium
- a changed authorisation process to make it easier for business start-ups, with an additional mobilisation option which allows a firm to accept deposits whilst it builds up the remaining requirements in relation to IT and capital[22]

2.28 On 11 September 2013, the OFT published its advice[23] to the Chancellor of the Exchequer concerning the impact on competition (including competition in aspects of SME banking) of divestments required under EU state aid rules, namely those by:

- Royal Bank of Scotland Group (RBS) of part of its retail banking business, subsequently named as Williams & Glyn (Project Rainbow)
- Lloyds Banking Group of part of its retail banking business, subsequently named as TSB (Project Verde)

In that letter the OFT advised that, based on its market share analysis, the divestments would only have a limited impact on the overall market structure for SME banking.

Objectives of the study and scope

Objectives

2.29 Given that competition in SME banking has already been the subject of considerable scrutiny and sustained focus, as referred to above, in this market study we have focused on building on and updating the existing evidence base to assess to what extent the sector exhibits the characteristics of a well-functioning sector. To us, a well-functioning sector is one which exhibits the following characteristics:

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[22] FSA, *A review of the requirements for firms entering into or expanding in the banking sector*, March 2013 (FSA/BoE, 2013).
[23] *OFT advice and recommendations to the Chancellor of the Exchequer*, 11 September 2013.

- **A banking sector which is customer-focused .** Providers' products are well suited to their customers' needs and are provided in a way that makes it easy for customers to make well-informed decisions about how and when they are used.

- **Consumers are sufficiently engaged with their banking services to drive competition.** Banks equip their customers to make better decisions about which products they use, and how they use them.

- **Competition between banks (and from non-banks) is driving providers to operate more efficiently and to innovate.**

- **Consumers have a broad choice of provider.** The sector is relatively less concentrated than it has been historically, and newer and smaller banks and/or new technology provide scope for increased competition from outside the traditional banking model.

- **Barriers to entry and expansion are lower.** Credible new players are able to join the market and have reasonable prospects for attracting the scale of customer base needed to achieve the economies of scale required to operate effectively.

2.30 Moreover, this market study is a 'Phase 1' study of the SME banking market in the context of the Enterprise Act 2002 markets regime. If any competition concerns are such as to warrant an MIR,[24] then it would be appropriate to undertake further detailed analysis of the sector during a market investigation (ie at 'Phase 2').

Scope

2.31 Following the launch of the market study, parties active in the industry expressed views about the scope of the market study. After consideration of these views, the OFT confirmed the scope of the market study on 27 September 2013, at which point detailed work commenced.[25] That scope is set out below by reference to products, geographic focus and issues.

[24] See the accompanying consultation on the provisional decision in relation to an MIR document for a detailed consideration of the MIR test and the circumstances which would warrant the exercise of the CMA's discretion to refer.
[25] Scoping document, issued by the OFT in September 2013.

Products

2.32 The products which the CMA and the FCA are focusing on during this market study are:

- **Liquidity management services**, by which we mean particularly BCAs and overdrafts[26]

- **Business loans**, which includes term loans (secured and unsecured). It does not include commercial mortgages[27]

2.33 This product focus is generally consistent with the conclusions of the CC inquiry, which identified the most significant competition concerns in relation to these products. The focus on BCAs is also reflective of the fact that a BCA often acts as a 'gateway' product for banks to provide customers with a range of services (something we discuss in Chapter 4). With respect to lending, we have focused on business loans, which, as we mention in Chapter 3, are the most common forms of SME lending, meaning that they are of relevance to a wide range of SMEs.

2.34 We also considered the supply of non-bank sources of finance, such as peer-to-peer lending (which in itself can be in the form of a term loan), sales finance (factoring and invoice discounting) and asset finance (finance leases, operating leases and hire purchases), but only to the extent to which they may exercise a competitive constraint on business loans.

2.35 There were a number of product types which we have not considered in any detail in this market study. These included non-lending products, such as insurance products, merchant acquiring, hedging services and foreign exchange services.

Geographical focus

2.36 We have considered competition in the following geographic areas: *(a)* England and Wales; *(b)* Scotland; and *(c)* Northern Ireland, which are consistent with the geographic market definitions adopted in the CC inquiry.

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[26] We have also considered short-term business deposit accounts. However, our consideration has been limited to considering whether there are certain common features between BCAs and business deposit accounts, such that our findings may also be applicable to those products.

[27] Albeit in practice, some banks have not been able to split out commercial mortgages and business loans in the information they have provided to us during the market study.

Issues

2.37 The main issues examined in this market study are:

- The nature and effectiveness of competition in SME banking:
  - — market structure and how banks compete – price, quality and service
  - — barriers to entry and expansion – updating the OFT's previous work on barriers to entry and the review of the changes to the authorisation regime conducted by the FCA
  - — the potential incumbency advantage of the BCA provider
- Switching:
  - — SMEs' willingness to shop around
  - — the level of switching, and barriers to switching
- Transparency:
  - — SMEs' ability to make effective comparisons between bank offerings and consequently make an informed decision as to the products that best meet their needs

Access to finance

2.38 We are conscious that access to lending products for SMEs has been a cause of significant public concern since the onset of the financial crisis.[28] However, while we accept that there is a linkage between competition and access to finance, having regard to the detailed work being conducted by public or governmental authorities on this issue,[29] we have not considered 'access to finance' concerns in detail in this study, except to the extent that they have directly resulted from, or otherwise been directly relevant to, specific competition concerns.

Methodology

2.39 During this market study the CMA and FCA have consulted widely with interested parties, including:

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[28] Indeed, there have been concerns about this issue over a longer period. See summary of the Macmillan report, published in July 1931.
[29] These include, for example, the Funding for Lending Scheme and the Enterprise Finance Guarantee. See information on various initiatives from government in relation to access to finance.

- the UK's largest banks, from which we have received a significant volume of detailed information (including some internal business planning documents), and with which we met throughout the market study

- smaller banks and alternative finance providers, many of which we also met during the market study

- representatives of the banking sector (including the British Bankers' Association)

- representatives of SMEs (including the Federation of Small Business, the Institute of Directors, the Confederation of British Industry, the British Chambers of Commerce and the Forum of Private Business)

- SMEs directly, through roundtables and focus groups held across the UK

- other public and governmental authorities, particularly HM Treasury, the Department for Business, Innovation and Skills (BIS), the Bank of England, the Prudential Regulation Authority and various agencies in the devolved nations

- organisations providing services to the SME banking sector (particularly providers of IT systems)

We are grateful for the assistance of these organisations during the market study, which has enabled us to understand a wide range of perspectives on the SME banking sector.

2.40 We have also considered a significant volume and range of published and unpublished reports on the sector, including:

- Reports prepared by a range of different organisations, including industry associations, government agencies and research bodies, including:

  — *Alternative Finance for SMEs and Mid-Market Companies*, produced by Ares and Co and commissioned by TheCityUK, October 2013[30] (CityUK (October 2013))

  — *SME Financing: Impact of Regulation and the Eurozone Crisis,* produced by Ares and Co and commissioned by TheCityUK, November 2012[31] (CityUK (November 2012))

[30] www.thecityuk.com/research/our-work/reports/list/alternative-finance-for-smes-and-mid-market-companies/.
[31] www.thecityuk.com/research/our-work/reports-list/sme-financing-impact-of-regulation-and-the-eurozone-crisis/.

— Independent Lending Review[32] (referred to in this report as the Large Review (2013))

— *Boosting Finance Options for Business*, 2013 (the Breedon Review (2013))[33]

— *SME Journeys towards raising External Finance*, commissioned by BIS from BMG, 2012 (BMG (2013))

— *Promoting competition in the UK banking industry,*[34] produced by the British Bankers' Association, 2014 (BBA (2014))

— Various reports prepared by analysts who are focused on financial services

- Various surveys of SME opinion,[35] particularly:

— the Charterhouse survey (Charterhouse)

— *Small Business Finance Monitor*, produced by BDRC continental (various editions)[36]

— *Snapshot of the UK SME banking market*, Datamonitor, March 2012 ((Datamonitor, 2012))

— *Northern Ireland Business Tracker*, PwC, Final Report, December 2012 (PwC (2012))

— *SME banking 2013* (YouGov (2013))[37]

— *Small Business Banking – UK*, Mintel, December 2013 ((Mintel (2013))[38]

— *BCA Transparency in the SME Market,* Quadrangle (2013)[39]

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[32] Independent Lending Review.
[33] www.bis.gov.uk/assets/biscore/enterprise/docs/b/12-668-boosting-finance-options-for-business.pdf.
[34] Promoting competition in the UK banking industry.
[35] These surveys have different coverage, reference times and methodologies, and are of varying quality. Results are not always consistent and where this is the case we have tried to present, on a comparable basis, the range of results from the different sources.
[36] www.sme-finance-monitor.co.uk/.
[37] The CMA has conducted its own analysis of the YouGov survey data to ensure the most appropriate and reflective weighting.
[38] Small Business Banking.
[39] Provided to us by LBG. We received two reports – one dated October 2013 and one dated November 2013. We refer to both as Quadrangle (2013), with an 'a' suffix for the October report and a 'b' suffix for the November report.

- Focus group research, particularly that which we commissioned from BDRC International in 2013 (BDRC focus group research – see Annex A) and that produced by the Payments Council in the context of the development of the CASS

- Academic research on aspects of the SME banking sector

Report structure

2.41 We present our analysis in the following chapters:

- **Chapter 3** gives an overview of the sector on both the supply and demand side. It describes the banking products available to SMEs, the characteristics of SMEs and diversity among them

- **Chapter 4** examines the structure of the SME banking market

- **Chapter 5** examines barriers to entry and expansion

- **Chapter 6** provides an overview of the demand side of the market (ie the needs, requirements and approach of SMEs using the retail banking services we are considering)

- **Chapter 7** considers the transparency of the product offerings available to SMEs, both in terms of price and service, which affects the ease with which SMEs can compare competing offerings

- **Chapter 8** examines searching, switching and negotiation in the sector by SMEs, particularly the extent to which SMEs shop around

- **Chapter 9** considers the performance of this market for SMEs in terms of price, service and satisfaction

- **Chapter 10** summarises briefly our competition assessment

- **Chapter 11** provides our assessment of the Undertakings, particularly considering whether there has been a realistic prospect of a change of circumstances since they were first given in 2002 and 2003

- The **annexes** include further background and details of our analysis

3. Overview of the SME banking sector

Introduction

3.1 SMEs are a highly diverse set of businesses, operating in different sectors, at different sizes and with significantly differing needs. In this chapter, we briefly introduce the range of SMEs, discuss the differing profiles of SMEs and the different range of products available to them, and then consider government initiatives regarding SME finance in the light of the financial crisis, to provide background to the analysis that follows.[40]

The SME segment

3.2 The CC inquiry defined SME banking as banking services for SMEs with an annual turnover of up to £25 million.[41] Although we use that definition throughout the market study, we recognise that this contains a very wide variety of different businesses with widely differing characteristics, financial needs and typical providers. Table 3.1 provides a simplified illustration of this diversity.

TABLE 3.1 **General characteristics of SMEs**

	Turnover	*Broad characteristics*	*Use of regular finance*	*Use of specialist finance (finance types explained below)*	*Typical providers*
Smallest micro businesses	Below £50,000	Cash-based firms, often part-time business; few tangible assets; local operations	Limited mainly to overdraft, loans and credit cards or personal finance products	Limited. Some asset-backed lending (ABL) – mainly vendor finance	Banks, credit card providers and point of sale (vendor finance)
Micro businesses	£50,000–£1m	Increasingly full-time firms with staff, premises and assets; local activity normally limited to a single region; occasional export	Overdraft, loans and credit cards	Increased use of structured ABL. Occasional use of trade finance products	Banks, credit card providers, specialised providers for ABL and trade products
SMEs	£1m–£25m	Full-time, larger multi-regional and national firms; increasing export/ import activity	Overdraft, loans	Still some use of ABL, factoring and invoice discounting, export finance, some equity finance	Banks, credit card providers, specialised providers, business angels, private equity

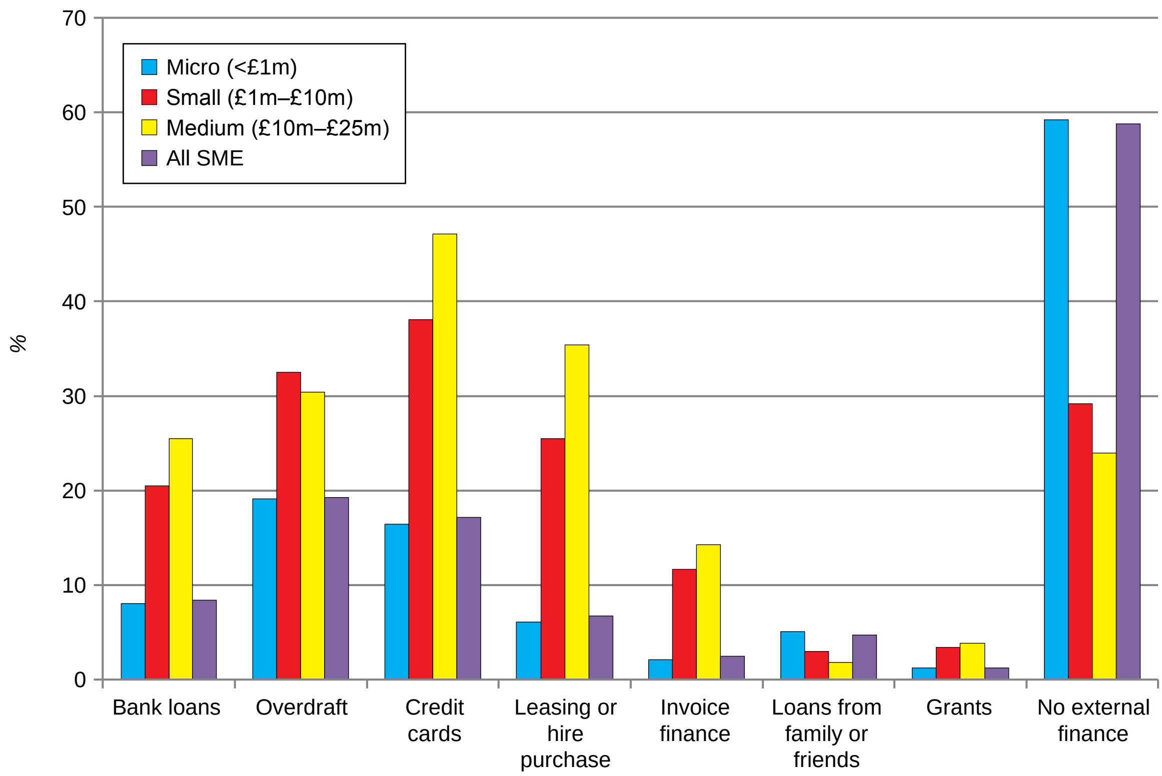
Source: 2010 Business Finance Taskforce Report.

[40] In addition to initiatives regarding SME finance, we note that following the financial crisis and issues of trust being raised about the sector, there have been recent moves towards self-regulation to improve standards and the reputation of the banking industry. A number of banks have agreed to set up a standards body for the banking industry called the Banking Standards Review Council. The Council will seek to improve the 'culture, competence and customer service' of banks with a focus on improving standards for high street banking customers.
[41] On page 17 of the CC inquiry, the CC acknowledges the difficulty of deciding on a dividing line between SMEs and larger businesses but regarded the limit of £25 million turnover used by the European Commission as reasonable. We continue to use this definition, although we recognise that it is different from that used in some other circumstances, such as by the FCA in the FCA Handbook or other purposes.

3.3 These differences between different SMEs and their financial needs is also reflected in their differential usage of financial products, with larger SMEs using a wider variety of financial products, as shown in Figure 3.1 below.

FIGURE 3.1

Sources of finance currently used by SMEs



Source: BDRC Small Business Finance Monitor, Q1 2014.

3.4 We consider these points in more detail in the following chapters, which set out our more detailed analysis.

3.5 This diversity is also reflected by each of the major banks, which segment their SMEs by reference to their size. This is illustrated in Table 3.2.

TABLE 3.2 **Segmentation of SME customers by the major UK banks**

Barclays	*HSBC*	*Lloyds**	*RBS*
Business Banking – turnover up to £5m	Business Banking Mass – turn-over up to £2m	Business banking – turnover up to £250,000	Business banking – turnover below £2m
Corporate banking – turnover over £5m	Business Banking Upper – turn-over between £2m and £30m	Commercial banking – turnover over £250,000	Commercial banking – turnover over £2m

Source: Information provided by the major banks.

*Not including Bank of Scotland.

3.6 While we recognise that any segmentation employed is necessarily a simplification, for the purposes of this study we have tended to focus on three categories of SMEs:

- **Start-up customers:** New SMEs, which are establishing a business banking relationship for the first time, and often benefit from introductory offers when they first take out a BCA.

- **Smaller established SMEs:** While the precise definition of this category is somewhat fluid, we note that for most banks, an established SME with a turnover of below £2 million would be included in this category. These SMEs, particularly those at lower turnovers in this band, will tend to have simple banking needs, often requiring a transactional relationship with their banks (eg making payments, cash handling).

- **Larger established SMEs:** These are often serviced by the commercial banking divisions of the banks, and generally include SMEs with a turnover of over £2 million. These SMEs will often have a greater degree of financial sophistication (including employing specific financial management staff) and are more likely to require a wider range of products and services than those required by smaller SMEs**.**

3.7 Alternative categorisations, which we also refer to at various points in this market study (and in the BDRC focus group research which we particularly refer to), are to specifically segment SMEs by reference to their financial needs:

- So-called '**transactors**' seek primarily to use their bank for transactions – making payments and cash handling. For these SMEs, the costs of using banking services will tend to be more important than the additional services which are provided by the bank.

- So-called '**relationship seekers**' seek a wider relationship with their bank. For these SMEs, the additional services provided by the bank will tend to be more important than the cost of the services.

SME banking services

3.8 We next consider the banking services available to SMEs, focusing first on the focal products for this market study, before considering a wider range of products available to SMEs.

Liquidity management services (BCAs and overdrafts)

3.9 BCAs are core business payment accounts. They are generally used to make and receive payments and to manage cash flow. SMEs may make payments involving these accounts in a number of different ways (over the counter in a branch, telephone or mobile/Internet banking) and through a number of different means (eg cash, cheque, direct debit, standing order).

3.10 SMEs are generally required to pay for each transaction they make from their bank (eg for a cash payment), although certain providers offer accounts where the SME pays a monthly payment for access to a set amount of services.

3.11 However, many banks offer a specific period of 'free banking' when a start-up SME opens a BCA, and also generally for SMEs which switch to that bank. During this period the SME is generally not required to pay transactional charges.[42] Table 3.3 shows the duration of free banking offerings for the four largest BCA providers.

TABLE 3.3 **Periods of free banking offered to SMEs by four largest banks**

Bank	*Start-ups*	*Switchers*
Lloyds	18 months	6 months
Barclays	12 months	Up to 6 months at relationship manager discretion in certain circumstances
HSBC	18 months*	6 months for up to £500,000 turnover Period of free banking may be negotiated with relationship manager for larger SMEs
RBS	2 years	6 months for SMEs with turnover up to £2m Period of free banking may be negotiated with relationship manager for larger SMEs

Source: Information provided by the largest banks.

*For start-ups with an annual turnover or projected turnover of up to £2 million.

3.12 Most banks have a published BCA price tariff which is applied to most SMEs. However, during the market study, we have found that larger SMEs often have bespoke pricing terms (something we consider further in Chapter 7). Banks also often have different tariffs for different transactional patterns, with most banks having a tariff for those SMEs dependent on branch usage and those that prefer an online-only offering.[43]

3.13 BCAs often offer overdraft facilities, a type of lending product, intended to meet working capital requirements, and typically include an interest rate and certain additional charges, for example if the authorised overdraft is exceeded.

[42] This tends to mean that charges do not apply for most core transactions, such as account usage, making deposits and withdrawals. However, certain other charges may also apply.
[43] There may also be specialist tariffs in place for SMEs in specific sectors.

BCAs and overdrafts

3.14 The revenues generated from the BCA sector were well over £2 billion in 2013.[44]

3.15 Banks typically obtain revenue from BCAs based on the following overall sources:

- transaction charges
- interest gained from holding credit balances
- interest earned from overdraft (debit) balances

3.16 Of these, transaction revenues have tended be the most significant source of revenue in recent years at most of the major banks.[45]

3.17 As would be expected, the average BCA transaction costs per SME increases with the size of the business. An SME with a turnover of £100,000 or less is likely to incur an average transaction cost of between £52 and £169 per year (depending on provider). In comparison, an SME with a turnover of between £1 million and £2 million is likely to pay an average of between £377 and £1,100 a year. This broad range reflects the fact that some providers are more reliant on transactional revenues, with others more reliant on income gained from credit and debit balances.[46]

3.18 At the end of 2013, overdraft use by SMEs in the UK was 10.9 billion according to BBA estimates.[47]

Business loans

3.19 Business loans are lending products whereby a bank lends a specific amount of money to an SME, with the requirement that it is repaid over a fixed time period. These account for almost 70% of all SME financing.[48] These loans may be secured against the assets of the SME and/or its owners or, in some cases, may be unsecured. The total value of outstanding balances on business loans was almost £90 billion at the end of 2013.[49]

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[44] Based on information provided to us by the banks during the market study.
[45] Based on analysis of information received by each of the five largest UK banks.
[46] Based on analysis of information received by each of the five largest UK banks.
[47] BBA, Bank support for SMEs – 4th Quarter 2013.
[48] CityUK (2013), p16.
[49] BBA, Bank support for SMEs – 4th Quarter 2013: 'The level of structured-term loans [to SMEs in Great Britain] was £89.0bn'.

3.20 Business loans include a rate of interest which the SME must repay. In addition, the following fees may be applicable, among others in certain circumstances:

- a fee for arranging the loan (an arrangement fee)
- in the case of secured loans, a fee which covers the costs in taking security (personal guarantees, debentures) for the loan (security fee)

3.21 Although there may be some fixed interest rate offerings, particularly for smaller SMEs, the pricing of business loans is often bespoke in nature. Applications for such loans are generally assessed by banks using a risk-based pricing model which relies on a number of key customer and loan characteristics. The interest rate applied will usually depend on the nature and size of the loan and the risk associated with the borrower.

Other forms of finance for SMEs

3.22 As we mention in Chapter 2, we recognise that there are a wide range of other lending products available to SMEs. We have also considered these other forms of finance to the extent that they exercise a competitive constraint over the focal products. The primary alternative forms of finance are:[50]

- invoice finance (accounting for around 8% of SME financing)
- asset finance (accounting for 9% of SME financing)
- trade finance (accounting for around 4% of SME financing)
- equity finance (accounting for around 1% of SME financing)
- alternative platforms (accounting for around 1% of SME financing)

These are briefly described below, with the exception of trade finance which is quite different in nature from the other financial mechanisms referred to above.

Invoice and asset finance

3.23 Invoice finance is the process by which an SME customer can transfer claims on outstanding invoices to a finance provider who (in exchange for a fee) transfers a certain percentage of the outstanding invoice value upfront in

[50] CityUK (2013), p16. This excludes overdrafts (which explains why the figures do not sum to 100) and is based on information from 2011 and 2010, which is the most recent available data which sets in detail the various types of available finance.

advance of payment of the invoice; this can therefore be an important source of working capital for SMEs. In the case of 'invoice factoring', the SME transfers the whole billing process to the asset finance provider whereas in the case of 'invoice discounting' the SME customer retains control over that process. We have been told during the study that invoice finance is increasingly being used as an alternative to overdrafts.[51]

3.24 Asset finance services to SMEs include leasing and hire purchase, and are commonly used in the purchase of capital equipment. In the case of leasing, the finance provider purchases the assets and leases them to the SME customer. In the case of hire purchase, the SME customer pays a deposit on a particular asset and gradually pays off the remaining balance, along with interest accrued.

3.25 Sales finance and asset finance are suitable only for certain types of SMEs, and only in relation to certain forms of borrowing. However, in some circumstances, the use of these types of borrowing may act as an alternative to borrowing through overdrafts and business loans. Indeed, we understand that there appears to have been a small increase in the use of asset and invoice-based finance to UK businesses, while the stock of other forms of bank lending has fallen.

Equity finance

3.26 Equity finance is the raising of capital through the sale of shares to investors. Angel investors, venture capital funds, early stage venture capital, mezzanine finance and private equity funds all provide equity finance.

3.27 However, we have been told that the use of equity finance is very limited in the UK, with usage being half the EU average and much lower than certain countries, such as Norway and Denmark.[52] While we have been told by various parties during this market study that the growth of equity finance would be strongly welcomed as an alternative to bank finance, it is unlikely to become an effective substitute to most forms of bank lending in the medium term, reflecting some reluctance on the part of at least some SMEs to lose control over any equity in their business. Instead, it is likely that, to the extent that this form of finance grows, it will support the larger SMEs with a greater ability to raise equity finance, rather than being relevant to the large majority of SMEs.

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[51] One bank, for example, noted that, in its view, factoring and invoice discounting were close substitutes to overdrafts. It also noted that invoice finance balances had increased while overdraft balances had decreased.
[52] *SMEs' Access to Finance Survey 2011*, December 2011, European Commission.

Alternative finance platforms, particularly peer-to-peer lending

3.28 In recent years, a number of Internet-based peer-to-peer, crowd funding and invoice trading lending platforms such as Funding Circle and Market Invoice have emerged, which target SMEs. These lending platforms directly match potential lenders to potential borrowers without involving a bank.

3.29 The available evidence suggests that these platforms have been growing strongly. Indeed, the UK alternative finance sector grew by 91% from £492 million in 2012 to £939 million in 2013. The UK alternative finance market provided £463 million worth of early-stage, growth and working capital to over 5,000 start-ups and SMEs in the UK from 2011 to 2013, of which £332 million was accumulated in 2013 alone.[53] However, despite this growth it continues to account for a very small share, around 1%, of lending to SMEs. Indeed, we note that, in relation to peer-to-peer lending, a recent study, providing the views of senior bankers, considered that 'peer-to-peer lending did not represent a real alternative to bank lending, even if volumes grew several fold in the next couple of years. Over time, alternative sources such as peer-to-peer lending would help to complement bank lending'.[54]

Deposit accounts

3.30 Deposit accounts enable SMEs to hold money on deposit at a bank or alternative finance provider, in exchange for which the bank pays interest. These may take various forms, including short-term deposit accounts (which we take to be those with less than 30 days' term or notice) and long-term deposit accounts (where the term or notice is greater than 30 days).

Linkages between PCAs and SME banking

3.31 As set out in Chapter 2, this market study is being conducted alongside the update of the OFT's 2013 review of the PCA market, reflecting what we see as similarities between the operation of the two sectors, particularly the providers of services and the behaviour of customers.

3.32 In addition, there is a more direct linkage between PCAs and SME banking, in that many smaller SMEs use PCAs, rather than a BCA, thereby avoiding the transaction costs that are normally charged on BCAs. The evidence regarding the extent of the usage of PCAs by SMEs varies:

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[53] Nesta (2013), *The Rise of Future Finance*. Nesta cautiously predicts that the UK alternative finance market will grow to £1.6 billion and provide £840 million worth of business finance for start-ups and SMEs in 2014.
[54] CityUK (2012), p50.

- Charterhouse, for example, indicates that 5% of SMEs used a PCA as their main account for business purposes in 2013 (rising to 7% among those with a turnover of below £100,000)[55]

- Research conducted on BIS's behalf in 2013 reported higher levels of PCA usage; 21% in that survey only used a PCA (falling to 11% among SMEs which were not sole traders)[56]

3.33 Moreover, the evidence indicates that in over half of instances in relation to most of the major banks, an SME will take out a BCA from the provider at which they hold a PCA. We consider this further in Chapter 4, in which we present our analysis of the linkages between different products.

3.34 During our market study, we have focused our analysis on BCAs (particularly given the parallel analysis which has been conducted in relation to PCAs). However, to the extent that there are linkages which are relevant to the analysis, we discuss them in the relevant chapters.

The financial crisis of 2007 to 2009 and government initiatives regarding SMEs

3.35 A critical element to the context for the market study is the financial crisis of 2007 to 2009 and subsequent recession, which had a highly significant impact on the banking sector, particularly through its effect on the viability of various providers of banking services (most notably RBSG and HBOS) and through contractions in the availability of finance to SMEs, as banks took action to repair their balance sheets.

3.36 Various interventions have been made by the Government and the administrations in the devolved nations, which impact on SME finance, including:

- various government schemes designed to facilitate access to finance, including the Funding for Lending Scheme (which we consider briefly in Chapter 5) and the Enterprise Growth Fund

[55] Charterhouse Q2, 2013. Question A6.
[56] BMG (2013), p7.

- the introduction of the British Business Bank (considered in the text box below)[57]

The British Business Bank

The British Business Bank (BBB) initiative is intended to unlock finance for smaller firms.

Over 8,000 businesses benefited from BBB in 2012, and its ambition is to unlock up to £10 billion of finance for smaller businesses over the next five years.

The BBB works in partnership with finance providers to develop diverse debt and equity funding solutions which help viable smaller businesses access the finance they need to grow. Some of the Bank's lending solutions include:

- the Enterprise Finance Guarantee (EFG), which encourages finance providers, including banks, to lend to viable smaller businesses that would otherwise be declined a normal business loan due to lack of adequate security
- a new programme being designed to provide guarantees on portfolios of new bank loans to small businesses, which will enable a diverse range of finance providers to use their capital and liquidity more efficiently and free up capacity

3.37 There have been similar initiatives regarding finance in each of the devolved nations.[58]

[57] The text in that text box is taken from HM Government (2013), *Small Business, GREAT Ambition*, p10. The British Business Bank's strategic plan was published in June 2014.
[58] For example, see that for Wales, Scotland and Northern Ireland.

4. Market structure – concentration

Key facts and findings:

- The supply of BCAs remains concentrated – 85% of BCAs in England and Wales are provided by the largest four providers, with the sectors in Scotland and Northern Ireland being even more concentrated. This is very similar to the position in 1999.
- The supply of business loans also remains concentrated – almost 90% by volume are provided by the largest providers in each of England and Wales, Scotland and Northern Ireland. Again, this is very similar to the position in 1999.
- Almost 60% of BCA customers at the four largest UK banks also have a PCA with the same bank, indicating the importance of the linkage between BCAs and PCAs. A strong propensity for start-up businesses to choose their BCA provider, based on where they hold their PCA, gives the larger banks an advantage over smaller stand-alone business bank providers and those lacking a strong presence in PCAs.

Introduction

4.1 As set out in Chapter 2, there have been long-standing concerns about the structure of the SME banking sector. Our findings in the following chapters indicate that these concerns remain and are significant. In particular, we found that high barriers to entry and expansion remain, as does a significant degree of concentration throughout the UK, but which is particularly pronounced in Scotland and Northern Ireland.

4.2 Concentration and barriers to entry and expansion are closely linked and interact with one another. However, we present our analysis of each of them separately for clarity, starting first with concentration.

4.3 This chapter presents our 'Phase 1' analysis of the current position with respect to concentration, including:

- the market shares in relation to the focal products
- comparisons with market structure in other markets
- the expected impact of the European Commission's required divestments
- the linkages between the market structure for BCAs and business loans (and the importance of the BCA as a 'gateway product')
- the relevance of concentration in the particular circumstances of this sector

Introduction to concentration

4.4 We recognise that there is no clear and simple relation between concentration levels and competition (and, in turn, better outcomes for customers). However, there is a tendency, all else being equal, for more concentrated markets to be less competitive. This tendency was observed by the Vickers review, in which it was noted that: 'Concentration is, of course, not deterministic of competition – competition is also affected by many other factors. Evidence [indicates] that, holding all else equal, higher concentration in retail banking leads to worse consumer outcomes.'[59] Measures of concentration therefore are often useful indicators of the intensity of competition in a market, particularly when products or services are not highly differentiated. Concentration may also, under certain circumstances, be a source of competition problems.

4.5 This tendency for concentrated markets to be less competitive is stronger when such markets are also characterised by significant barriers to entry and consumers who are inactive in terms of shopping around for the best offer (each are concerns which we explore in later chapters). This is because these factors make it less likely that the main market participants will lose customers to rivals and new entrants with a better customer offering over time and hence reduce the incentives on incumbents to compete.[60]

4.6 Moreover, persistently high levels of concentration can be a strong indicator that competition is not working well in a market. High and stable market shares can indicate that competition between providers lacks intensity, in so far as we would usually expect competition between firms to result in the most efficient or innovative providers gaining customers from less efficient or innovative providers, thereby resulting in changes in market shares over time. In particular, if market shares are stable over time despite differences in prices and service levels of different providers, this can be a strong indicator of customer inertia and barriers to switching by customers.

4.7 We consider first what we have found in relation to concentration, before considering its implications in the particular circumstances of this sector.

[59] See the ICB report, Annex 4, paragraph 15. The ICB report included a detailed summary of relevant empirical literature regarding the link between competition and concentration, which we have reviewed during the market study. Of particular relevance to this market study is Shelagh Heffernan, 'UK bank services for small business: how competitive is the market?', *Journal of Banking and Finance* 30 (2006), pp3087–3110. We note that several of the banks disputed the findings of the ICB report regarding concentration.

[60] Our focus in this market study is on identifying whether any competition issues arise in relation to SME banking markets. However, it is also important to recognise that concentration in banking has raised concerns in relation to financial stability, and this has been highlighted following the events of the financial crisis (see, for example, p11, 'On being the right size'. Speech given by Andrew Haldane, Executive Director, Financial Stability and member of the Financial Policy Committee, Institute of Economic Affairs, 22nd Annual Series, 2012 Beesley Lectures, 25 October 2012).

Market shares and concentration in SME banking

4.8 In this section, we set out current measures of market share and concentration. In doing so, we begin by identifying the product and geographic markets we will consider in terms of market shares and concentration, taking as our starting point the markets identified in the CC inquiry. Then we set out measures of market share and concentration for these product and geographic markets.

Relevant product markets

4.9 As described in Chapter 2, throughout this market study we have focused on liquidity management services (predominantly BCAs) and business loans which, consistent with the CC inquiry, form the relevant product markets for our analysis.

Relevant geographic markets

4.10 The three relevant geographic markets the CC adopted in its 2002 report were *(a)* England and Wales, *(b)* Scotland and *(c)* Northern Ireland.[61] For the purposes of this Phase 1 market study we have used these same geographic market definitions. This is also consistent with the OFT's approach when assessing the Lloyds/HBOS merger in 2008.

4.11 We also recognise that there may be local geographic markets with competitive conditions that are particular to them. Local branches are important to many SMEs, as we will see in Chapter 5. Pricing may also have a local aspect for those larger SMEs which are in a position to be offered bespoke/negotiated pricing by their bank. However, it has not been possible to undertake an assessment of local market conditions during this Phase 1 market study.

Significance of market shares

4.12 Market shares are likely to be more informative about the likely extent of market power when products are not highly differentiated. With regard to SME banking markets, there is a great deal of similarity in the BCAs and business loans offered by the main banks. The functionality of a BCA or a business loan, for example, is generally the same across providers. While there may be some differences in features (eg text alerts when breaching certain account limits, relationship services or loan approval arrangements), or in SMEs'

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[61] When considering two other product markets, 'other types of business loans' and 'other business deposit accounts', the CC found the relevant market to be UK-wide.

perception of the different banking brands, overall SMEs appear to believe the main banks are very similar in their offerings (something we consider again in later chapters). However, we recognise that aspects of product or service differentiation may be important for some SMEs. These aspects of differentiation may reduce, to some extent, how fully reflective market shares are of competitive conditions.

BCAs[62]

4.13 In this section we set out estimates of market shares and concentration for each of the three geographic markets by reference to main banking relationships, that is based on BCAs.[63] First, however, we note that the supply of BCAs in Great Britain is itself concentrated, with the HHI[64] showing that concentration in Great Britain has been consistently well above the benchmark for a concentrated market and close to that of a highly concentrated market since the year 2000, as shown in Figure 4.1. This is consistent with BBA research which finds the BCA sector to be 'relatively more concentrated [than other retail banking sectors]' and to be around a HHI level which would indicate the sector to be highly concentrated'.[65]

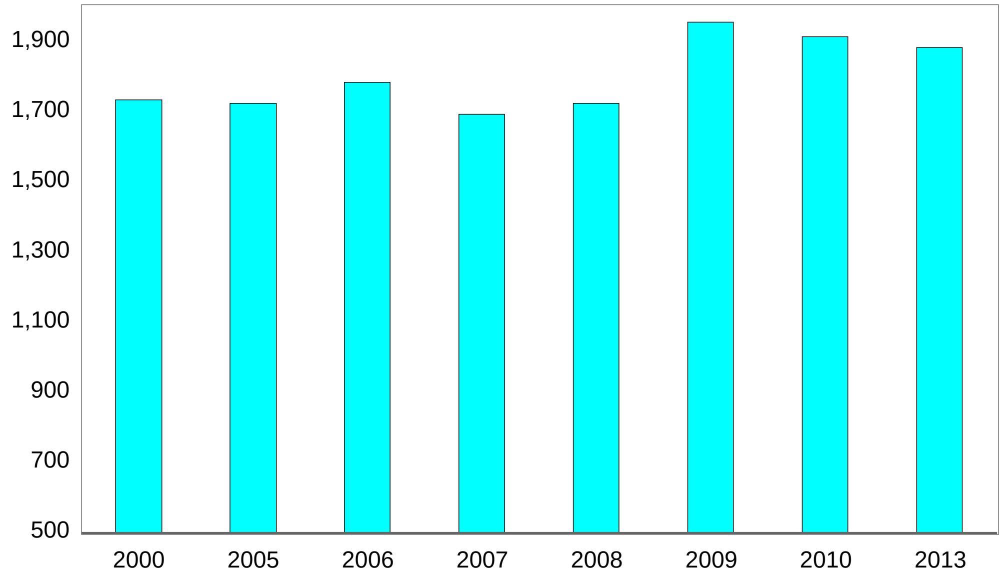
An explanation of HHIs

- The Herfindahl-Hirschman Index (HHI) is a **measure of market concentration** that takes account of the differences in the sizes of market participants, as well as their number. The HHI is calculated by adding together the squared values of the percentage market shares of all firms in the market.
- In relation to mergers, the CMA may have regard to the following thresholds: any market with a post-merger **HHI exceeding 1,000 may be regarded as concentrated** and any market with a post-merger **HHI exceeding 2,000 may be regarded as highly concentrated**.

[62] In light of the fact that almost 95% of SMEs obtain their overdraft from their provider of a BCA, we would expect that there is only limited difference between BCA and overdraft market shares.
[63] We have taken main banking relationship to reflect the bank at which an SME holds its main BCA, although we note that there may be some small discrepancy between the two. This is consistent with the approach taken in the Vickers review.
[64] See the box above and the CMA *Merger Assessment Guidelines, CC2*, paragraphs 5.3.4 & 5.3.5.
[65] BBA (2014), p41.

FIGURE 4.1

Concentration in BCA supply in Great Britain as measured by the HHI



Source: ICB analysis of CC, TNS and Charterhouse data for 2000–2005. CMA/FCA analysis of Charterhouse data for 2013.
Note: Analysis for SMEs with less than £1 million turnover.

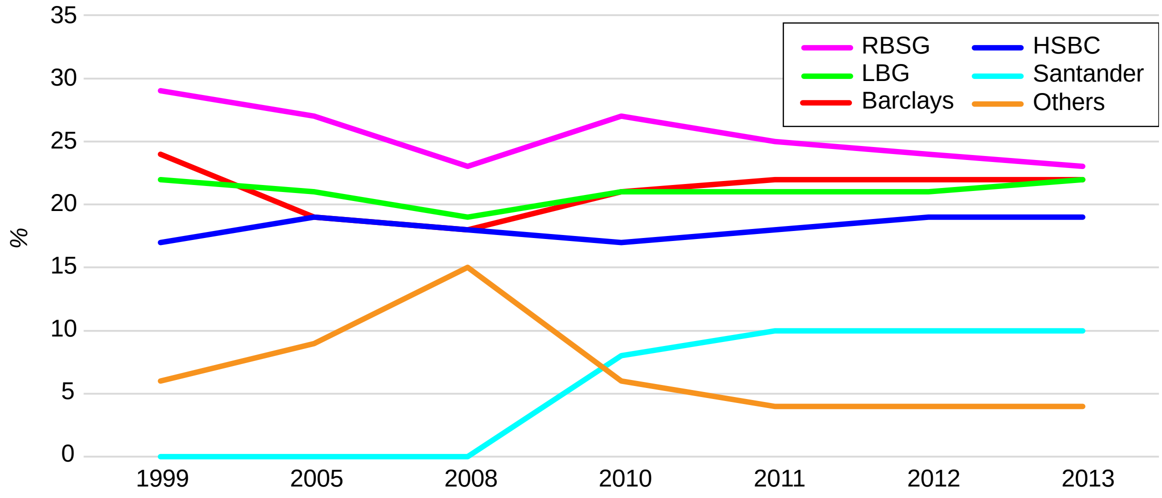
BCAs: England and Wales

4.14 In England and Wales, the UK's four largest banks have accounted for at least 85% of SMEs' main banking relationships for the past 14 years, as shown in Figure 4.2 below.

4.15 In 2013, the market had a HHI of 1,974, which is somewhat reduced from 1999 when the HHI was 2,228. This decline in concentration is largely explained by the emergence of Santander, which has grown mainly through the acquisition of existing market participants rather than through organic growth.

FIGURE 4.2

Market shares in the provision of BCAs to SMEs by volume of accounts/ main banking relationships, England and Wales



Notes:
1. Based on data for the years 1999, 2005, 2008, 2010, 2011, 2012, 2013. (There may be some further variation in market shares in the years not covered due to lack of data.)
2. Data from 1999, 2005 and 2008 is from the two OFT reports: 'Barriers to Entry in Retail Banking' (2010) and OFT (2007). Data for the years 2010 to 2013 is from Charterhouse. There are methodological differences between Charterhouse data and the CC and OFT calculations, but the data remain broadly comparable.
3. Alliance & Leicester and Abbey National leave the series after the 2010 data set, HBOS after 2008.

4.16 The evidence presented above shows that the market shares of the major banks in England and Wales have remained relatively stable over the past four years. Indeed, over an even longer period, similar trends can be observed, with the limited changes that there have been largely arising from mergers and acquisitions (eg the merger of Lloyds/HBOS in 2008), rather than through organic growth. Indeed, concentration levels now appear higher than they were when the OFT last reviewed the market in 2007.[66]

BCAs: Scotland

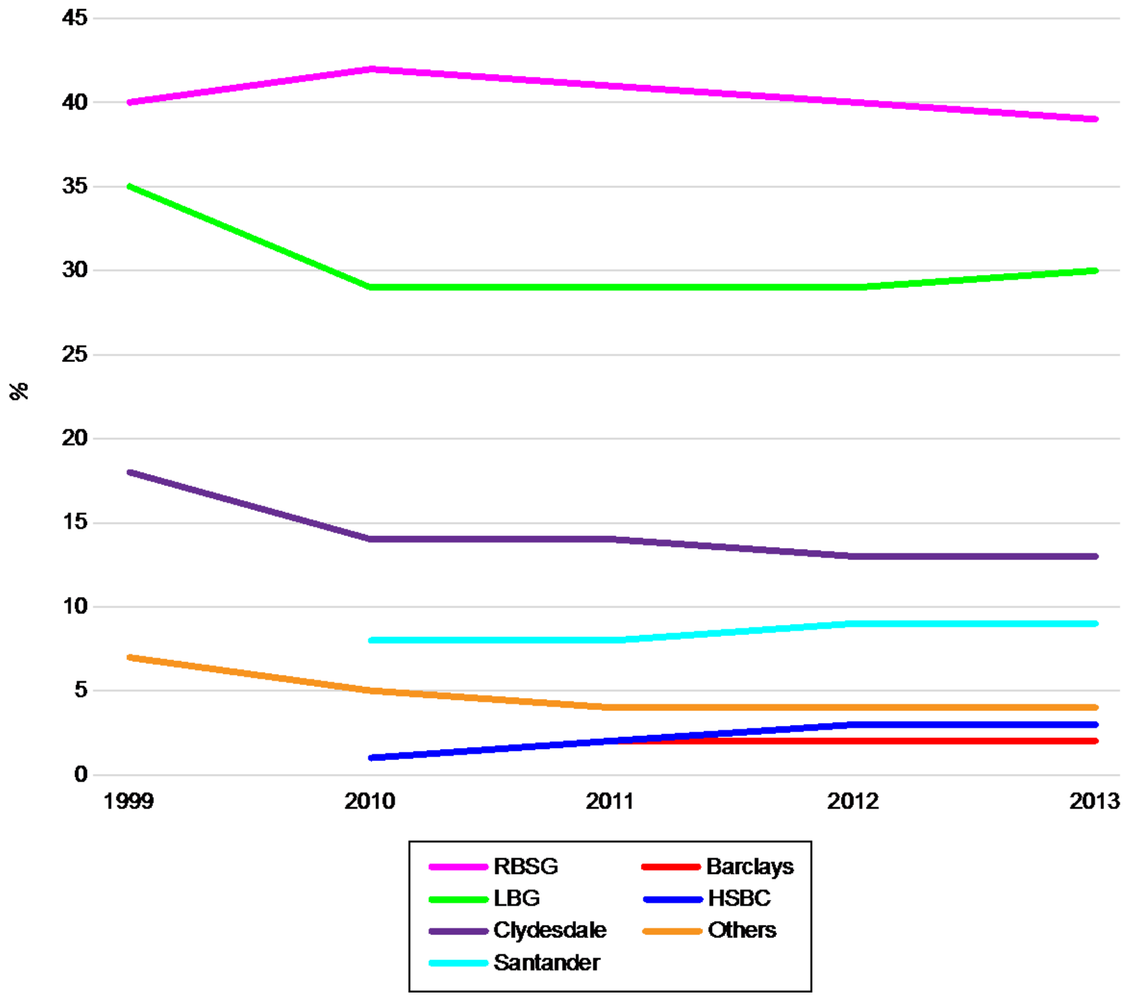
4.17 The BCA sector is somewhat different in Scotland, where the largest three banks (RBS, Lloyds and Clydesdale) have accounted for over 80% of the main banking relationships of SMEs since 1999, with the largest two providers accounting for some 70% as shown in Figure 4.3 below. In 1999, the HHI in

[66] The market shares presented above indicate the banks' shares of the stock of customers in any particular year. It is also possible to consider banks' shares of the flow of new SME banking customers joining all the banks. The flow of SME banking customers arises from both SMEs switching provider and SMEs which are new to the market (eg start-ups). Considering the share of the flow of customers may provide a better indication of current competitive conditions, which may differ from historical competitive conditions, particularly if the profile of shares is rather different between the stock and the flow. The flow may also indicate whether certain banks may be expected to grow strongly as a strong flow feeds into their share of the stock over time. However, based on Charterhouse data from the year preceding Q2 2013, we found the profile of the shares of the flow of new SME customers to be broadly similar to the share of the stock of existing customers. Therefore, we do not present this analysis here.

Scotland was 2,950, reducing to 2,720 in 2012 (reducing further to 2,348 when the expected effect of the Verde divestment is included), indicating a highly concentrated market even after the divestment from Lloyds.

FIGURE 4.3

Market shares in the provision of BCAs to SMEs by volume of accounts/main banking relationships, Scotland*



Source: 1999 figure from CC's 2002 report; 2010–2013 figures from Charterhouse Q2 2013 submission.
*There are methodological differences between Charterhouse data and the CC calculations, but the data remain broadly comparable.

4.18 The evidence presented above shows that the market shares of the major banks in Scotland have remained relatively stable over the last 15 years, albeit with some slight reductions in the market shares of Lloyds/Bank of Scotland and also of Clydesdale.

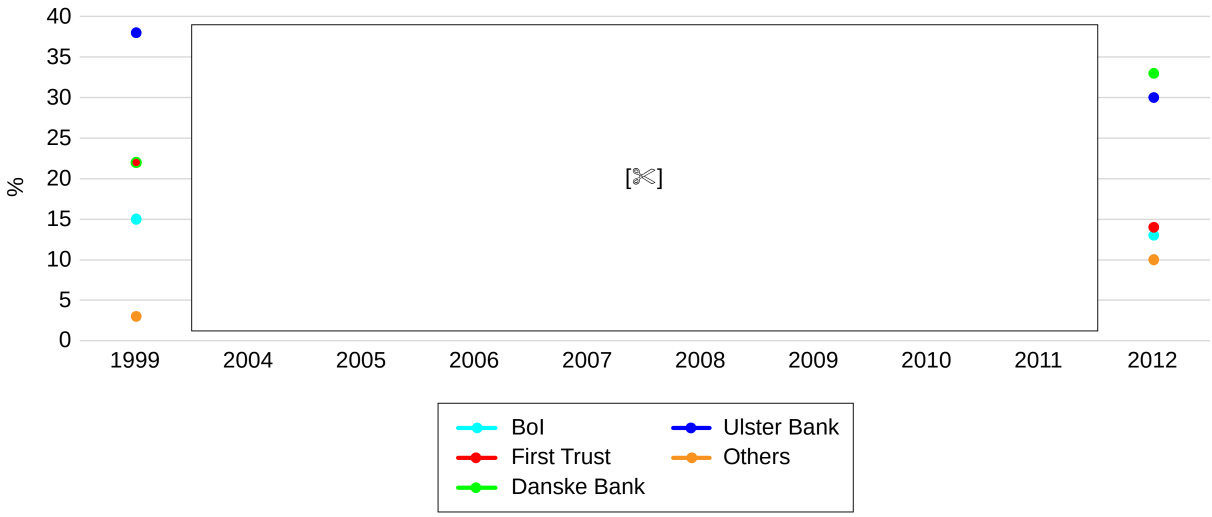
4.19 We note that Barclays and HSBC, despite the scale of their operations in England and Wales and their expertise in providing banking services to SMEs, have not grown significantly in Scotland during the period examined above.

BCAs: Northern Ireland

4.20 In Northern Ireland, there are two large and two mid-sized market participants. In 2012, Danske Bank and Ulster Bank (the latter part of RBSG) together accounted for 63% of the liquidity management services market.[67] They are followed by First Trust and Bank of Ireland with market shares of 14% and 13% respectively, as shown in figure 4.4. The HHI for the Northern Irish market in 2012 was 2,454, a slight decrease in the market concentration level from 2,646 in 1999, but still indicative of a highly concentrated market.

FIGURE 4.4

Market shares in the provison of BCAs to SMEs by volume of accounts/ main banking relationship, Northern Ireland*



Source: 1999 figure from CC 2002 report; 2004 to 2012 figures from PwC report on Northern Ireland, 2012. There are methodological differences between the PwC and the CC calculations, but the data remains broadly comparable.
*PwC (2012), p18, margin of error +/– 2.5%.

4.21 The evidence above shows that the market shares of the major banks in Northern Ireland, despite some limited fluctuations (particularly before 2004), have remained relatively stable over the last eight years.

4.22 We note that Barclays, Lloyds and HSBC, despite the scale of their operations in England and Wales (and Scotland in the case of Lloyds) and their expertise in providing banking services to SMEs, have not grown organically in Northern Ireland.

[67] PWC (2012), slide 8. This is based on SMEs indicating which is their main financial institution.

Business loans

4.23 We now consider market shares in the supply of business loans, focusing on survey evidence, which indicates with whom SMEs hold their business loans. This allows for the calculation of the market shares based on the volume of loan accounts. We also briefly consider shares of the value of lending below, although these concern a broader range of lending products than the focal products which are the subject of this market study.

Business loans: volume shares of lending[68]

4.24 The CC inquiry showed that each of the three geographic markets for business loans was concentrated:

- In England and Wales, the four largest providers had a market share of some 90%, with RBS, Lloyds and Barclays each having a market share of over 23%
- In Scotland, the three largest providers had a market share of some 90%
- In Northern Ireland, the four largest providers had a market share of some 90%, with Danske, Ulster and First Trust each having a market share of over 23%[69]

4.25 In the charts below, for each of England and Wales, Scotland and Northern Ireland, this pattern of concentration persists (albeit we recognise that the information may not be directly comparable as between 1999 and 2013), with each of the markets being either concentrated or highly concentrated, as shown in the accompanying HHI figures. With respect to Santander, we understand that its relatively lower market share for business loans in England and Wales reflects the profile of its customers, many of whom are very small and have limited borrowing needs; this means that, in general, business lending markets are more concentrated among the largest providers than the BCA markets.

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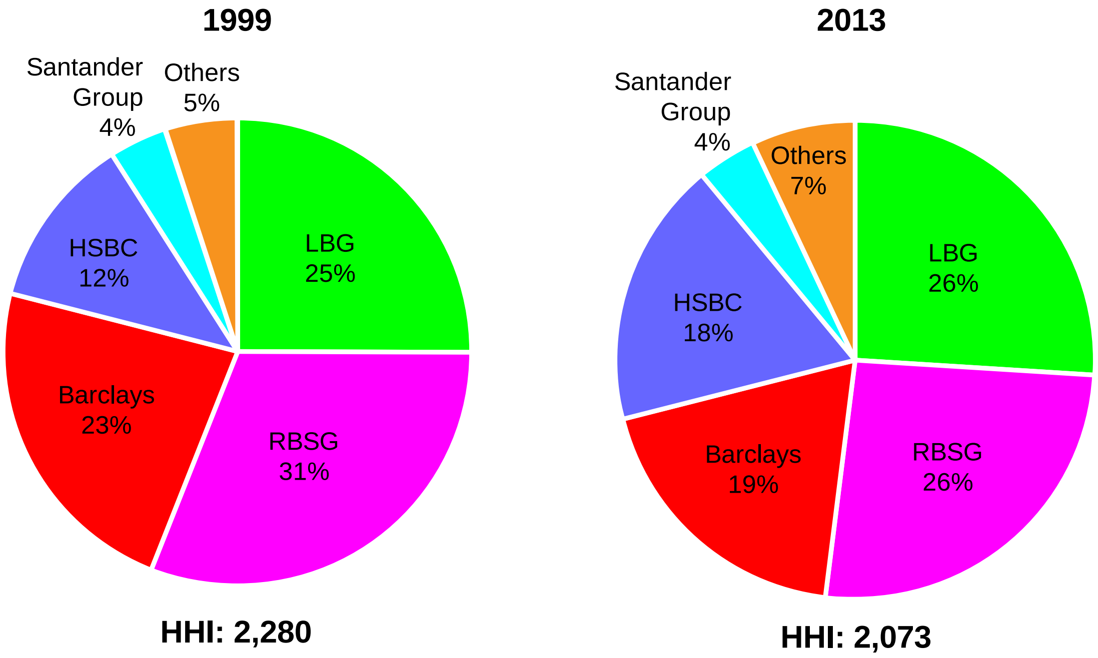
[68] We have used results from Charterhouse, which asks respondents which provider(s) they have used in the last 12 months for 'business loans (structured/term loan)' for volume information. This definition of business loan appears to match with the definition of business loans used in this report. It must be noted, however, that previous market shares calculated in the CC inquiry included banks' shares of commercial mortgages as well as business loans.
[69] CC (2002), p25.

FIGURE 4.5

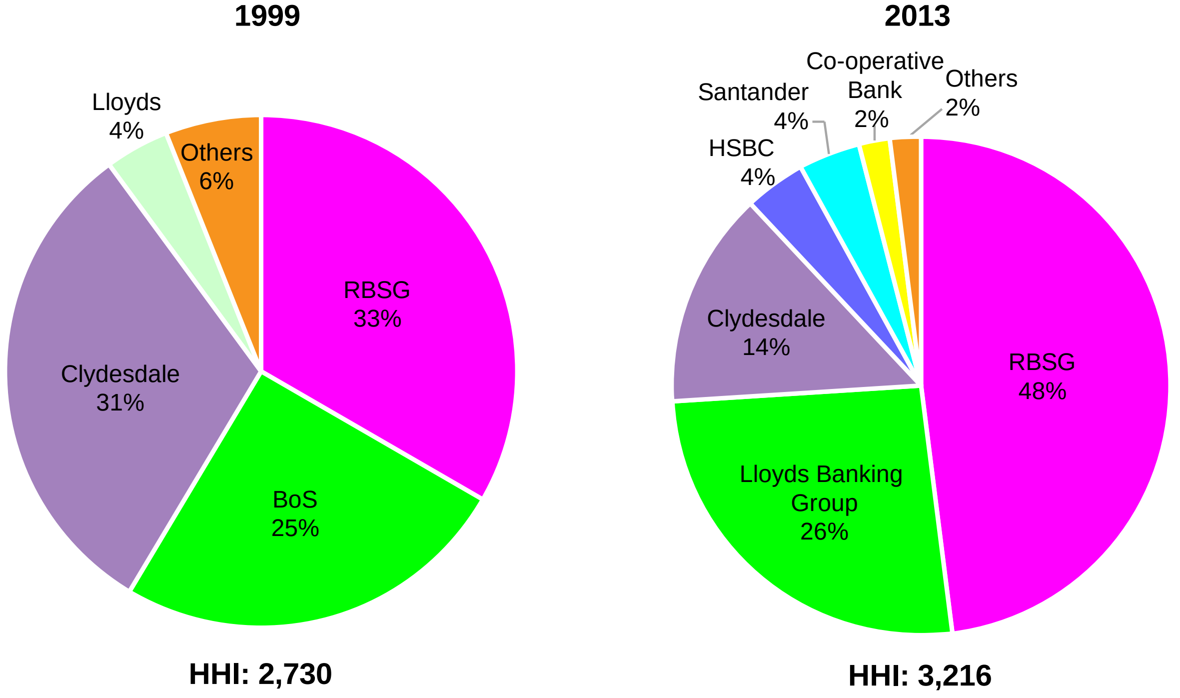
Volume shares of business loans in England and Wales, year ended Q1 2013*



Source: 1999 figures from CC, 2013 figures from Charterhouse release Q1 2013.
*Percentages may not sum to 100 because of rounding.
Note: We have treated all the banks in ‘others’ as a single entity for the purposes of calculating the HHI in 2013. However, if others were treated separately and it was assumed that they each had a market share of less than 1% then the HHI figure would drop to 2,057. There are methodological differences between the calculations made in 1999 and 2013, including the inclusion of commercial mortgages in the 1999 figures, which mean that graphs are not entirely comparable.

FIGURE 4.6

Volume shares of business loans in Scotland, year ended Q1 2013*

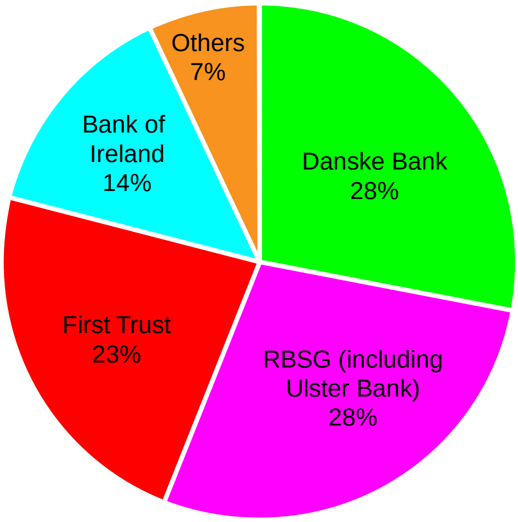


Source: 1999 figures from CC, 2013 figures from Charterhouse release Q1 2013.
*The Charterhouse (2013) sample size for Scotland is fairly small (119), and so may not be as robust as the findings for England and Wales.
Note: We have treated all the banks in the 'others' as a single entity for the purposes of calculating the HHI in 2013. However, if others were treated separately and it was assumed that they each had a market share of less than 1% then the HHI figure would drop to 3,212.There are methodological differences between the calculations made in 1999 and 2013, including the inclusion of commercial mortgages in the 1999 figures, which mean that shares are not entirely comparable.

FIGURE 4.7

Volume shares of business loans in Northern Ireland, 1999 and 2012

1999 **2012**



[✂]

HHI: 2,330 **HHI: [✂]**

Source: 1999 figures from CC, 2012 figures from PwC Northern Ireland Business Banking Tracker, December 2012.
Note: There are methodological differences between the calculations made in 1999 and 2013, including the inclusion of commercial mortgages in the 1999 figures. This means that shares are not entirely comparable. We have treated all the banks in 'others' as a single entity for the purposes of calculating the HHI in 2012. However, if others were treated separately and it was assumed that they each had a market share of less than 1% then the HHI figure would drop to [✂].

Business loans: market shares based on the value of lending

4.26 We have also considered various sources regarding the market shares of lending held by the major banks by value. However, unlike the volume information above, which is available for the various providers for business loans, such information is not readily available for the value of business loans. To the extent that information is available, it tends to include a much broader range of lending products than the focal products included in the market study. With respect to total lending generally, the evidence indicates that, by value, the major banks have a lower market share than they do in relation to the volume of business loans, reflecting the wider variety of providers of specialist lending products. [✂][70,71]

[70] [✂]
[71] Bank of England, Trends in Lending (April 2014).

Market shares by customer turnover

4.27 As we set out in Chapter 3, there is significant diversity of SMEs. We have therefore considered whether concentration levels of providers differ by turnover of the SME, such that particular segments of the markets may be less concentrated. We set out, in Figure 4.8 below, our analysis with respect to England and Wales for main banking relationships. While we note that there are some differences in concentration levels by turnover band, most notably for the largest of SMEs, where there is a greater proportion of ‘others’, and a lower share of supply from Santander (as explained above), we observe that these differences are limited with the largest providers together accounting for over 80% of SMEs’ main banking relationships in each of the turnover segments we present below.

FIGURE 4.8

Shares of supply (main banking relationship) by turnover bands, England and Wales, 2013

[✂]

Source: Charterhouse, Q3 2013.

4.28 We have repeated this analysis for each of Scotland and Northern Ireland, and note that they exhibit very similar results to those in England and Wales, with very limited differences in provider market share in different turnover segments. See Annex B for the relevant charts.

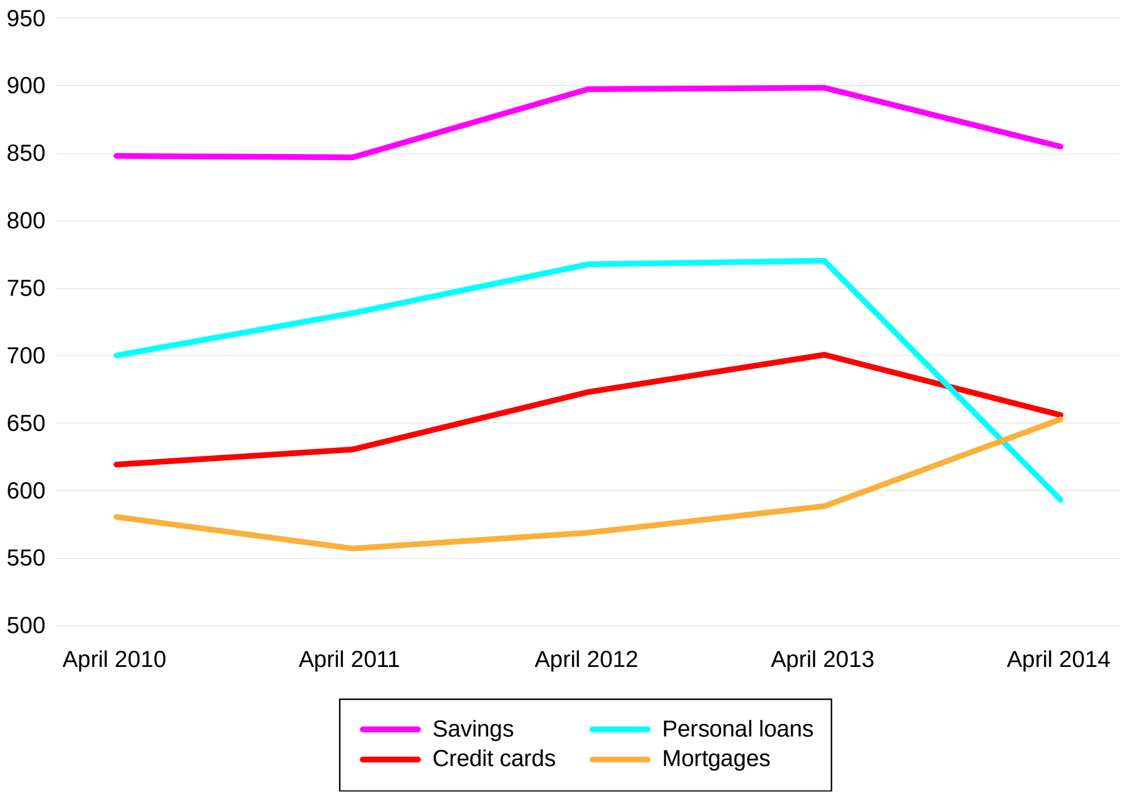
Comparisons with (a) other product markets and (b) SME banking in other countries

4.29 While comparisons with other markets, either domestic or international, can yield useful insights into the relative degree of concentration in SME banking and thus may allow for an examination of consumer outcomes between markets which may be affected by concentration levels, we also recognise the difficulties associated with making meaningful comparisons between different markets. This difficulty reflects the potential for comparator markets to possess significantly different characteristics from the focal product markets for a range of historical, political, social and economic reasons.

4.30 We have considered (in Figure 4.9) relative concentration levels for SME banking services, compared with other retail banking products, including personal loans, savings and credit cards. This shows that the HHIs seen in these sectors are under 1,000 in each of the last five years, which is significantly less concentrated than what we have observed above in relation to the focal products. We also note that the PCA market is less concentrated, as set out in the accompanying PCA update review,[72] than the focal product markets considered in this market study.

FIGURE 4.9

Concentration levels for various UK retail banking products measured using the HHI



Source: CMA calculations based on GfK data.

4.31 We have also considered international comparisons in relation to concentration levels. In doing so, we have considered previously published research and approached other competition authorities in the EU and the USA to assess the extent and value of comparative information that may be available from those other jurisdictions. However, the significant differences in important national dynamics operating between jurisdictions mean that we do not consider these comparisons to provide meaningful insights that would be of direct relevance to our market study. Annex C sets out a high level summary of our findings.

The expected effect of the required divestments by Lloyds and RBS

4.32 In addition to considering current levels of concentration, we have also considered the likely impact of the ongoing divestments which are required to

[72] See the market study into PCAs which is published alongside this market study.

be made under EU state aid rules by LBG of TSB and by RBSG of Williams & Glyn (W&G).[73] As we mention in Chapter 2, the OFT was asked by the Chancellor of the Exchequer to provide advice concerning the impact on competition of these divestments. The OFT's advice, which was published on 11 September 2013, found that:[74]

- In England and Wales, the divestment of W&G should lead to a new entrant with a market share of around 5% and a consequential fall in concentration.
- In Scotland, the creation of TSB with its 8% share of BCAs is expected to reduce concentration in SME banking, while W&G will have a very limited presence.

4.33 Overall, the divestments from RBSG and Lloyds are expected to reduce concentration in both England and Wales, and in Scotland. However, as the OFT's advice to the Chancellor notes at page 5, 'the divestments will only have a limited impact on overall structure in PCAs and SME banking'.

4.34 In addition, and in any event, we note that the divestment of W&G from RBSG has been deferred until 2016.

Linkages between different products – the importance of 'gateways'

4.35 During the market study, we have given particular attention to the linkages between different products, particularly the extent of the so-called 'gateway effect', whereby a customer holding a particular product from a bank is more likely to hold other products at the same bank. In this case, we note that there appear to be significant linkages between:

- SMEs being significantly more likely to obtain a BCA from the provider where they hold their PCA
- SMEs being significantly more likely to obtain a business loan from the provider where they hold their BCA
- SMEs being significantly more likely to obtain a range of banking products from the provider where they hold their BCA

[73] State aid No N 422/2009 and N 621/2009 – United Kingdom Restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme, and State aid No 428/2009 – United Kingdom Restructuring of Lloyds Banking Group.
[74] See OFT letter to the Chancellor of the Exchequer.

Given the significance of the largest four providers in the markets for PCAs[75] and BCAs, this linkage or potential gateway is likely to be an important explanation for the market structures we have observed above. In particular, the linkages between products could mean that a strong presence in the supply of one product is likely to give a significant advantage in the supply of another product. A potential entrant into one of these markets may then find that, in order to be successful, it needs to enter multiple markets and develop a strong position across a range of products. This, in turn, is likely to increase the costs of entry into any single product market. The gateways discussed below suggest that, in order to have a strong presence in term loans for businesses, a strong presence in the supply of BCAs is likely to be a major advantage, and in order to have a strong presence in the supply of BCAs, a strong presence in the supply of PCAs is likely to be a major advantage.

4.36 We consider each of these linkages below.

The PCA–BCA linkage

4.37 During the market study, we have seen evidence of the importance of an SME's PCA provider in explaining its choice of BCA at the time of start-up. Table 4.1 below, for example, shows the proportion of SMEs whose owners or managers already had a personal banking relationship with a bank before choosing that same bank to be their BCA provider. It shows that more than [✀]% of Lloyds and Barclays customers already banked with these providers in a personal context. The figure for HSBC is [✀]%, [✀]% for NatWest and [✀]% for RBS. Santander trails this on [✀]%, while it is lower again for smaller banks. This indicates that holding a PCA with a bank is likely to be an important influence on an SME's choice of BCA provider.

[75] See the market study into PCAs which is published alongside this market study.

TABLE 4.1 **Main bank for personal banking before business was set up**

Provider	*PCA to BCA conversion rate %*	*Base size*
Barclays Bank	[✂]	667
Lloyds	[✂]	744
HSBC	[✂]	485
NatWest	[✂]	580
Santander Group	[✂]	314
RBS/The Royal Bank of Scotland	[✂]	275
Co-operative Bank/Co-op	[✂]	68
HBOS/Halifax/Bank of Scotland	[✂]	460
Clydesdale Bank	[✂]	65
Yorkshire Bank	[✂]	48
Nationwide	[✂]	152

Source: Charterhouse business banking survey results YE Q2 2013.

Note: The Charterhouse Business Banking survey does not separately identify SMEs with banks with very small respondent numbers. These have been grouped into an 'other' category (eg Handelsbanken). It is therefore not possible to obtain conversion rates for customers of these banks.

4.38 This is consistent with the information we have received from each of the four major banks, all of which have provided us with information that considerably above 50% of their BCA customers also have a PCA from them.

The BCA–loan gateway

4.39 We observe that the banks which have high, and relatively stable, market shares in the supply of BCAs in each of the relevant geographic markets similarly have high shares in the supply of business loans.

4.40 This reflects the strong tendency we observe for SMEs to obtain a business loan from their BCA provider, such that the BCA appears to act as a so-called 'gateway product'. This is demonstrated through various surveys which confirm that the vast majority of SMEs source business loans through their main bank, where they will hold their BCA (see Table 4.2 below). This does not change significantly depending upon the relative size of the SME.

TABLE 4.2 **Proportion of SMEs sourcing business loans via their main bank by SME size**

	SME Finance Monitor (Q1 2011 to Q2 2013)	*Charterhouse Business Banking Survey Q3 2013*
All	87	89
Smaller SMEs (less than £2m turnover)	87	90
Larger SMEs (more than £2m turnover)	89	85
Base (all SMEs)	2,670	312

Source: SME Finance Monitor Q1 2011 to Q2 2013, Charterhouse Q3 2013.

Linkages between BCAs and other products[76]

4.41 Other evidence we have seen indicates that, similar to the linkage between BCAs and business loan products, SMEs tend to obtain a wide range of banking products from their main bank only.

TABLE 4.3 **Linkages between BCAs and other products**

Product	*Proportion of SMEs which obtained the following products from their main bank only* *%*
Overdraft	94
Instant access deposit account	91
Term deposit	81
Company credit card	88
Commercial mortgage	72
Invoice finance	68
Asset finance	35

Source: Charterhouse Q3 2013.

4.42 We consider this issue in more detail in Chapter 8. At this stage, however, we merely note that these linkages may be part of the explanation for the similar market structures we have seen in BCAs and business loans, as that for PCAs.

Conclusions on market structure

4.43 The above evidence shows that the supply of the focal products remains concentrated, as they have been for well over a decade, and that these concentration levels exceed those in other financial services markets. Moreover, while the ongoing and proposed divestments from Lloyds and RBSG will result in some reductions to concentration levels, they are expected to have only a limited impact on the structure of the SME banking market into the future.

The implications of concentration in the SME banking sector

Effect of concentration on single-firm conduct

4.44 If SMEs face deterrents to switching banks (such as high costs or difficulties or other impediments such as those discussed in Chapter 8), then they are less likely to react to a relative increase in price by their current provider by moving to an alternative provider. This gives rise to firms having some degree

[76] We consider business deposit accounts separately in Annex D.

of market power over their existing customers.[77] Therefore, higher concentration can lead to higher prices or poorer service if customers believe there to be deterrents to switching, as banks may find that the incentive to exploit 'locked-in' customers (through the higher margins to be gained from higher prices and from failure to invest in service improvements and innovation) exceeds the incentive to offer lower prices (or improved service) so as to attract new customers. In particular, if there is limited opportunity to gain new customers, due to low rates of switching or few new consumers entering the market, then a price decrease may be more likely to reduce, rather than increase, profits for a bank.

4.45 When a bank considers reducing the price it charges all its customers for a service (or investing in higher service standards and innovation), it will calculate the gain in revenue it is likely to receive from thereby attracting additional customers. The bank will compare this with the reduced revenues it will receive from those customers who already purchase from it.[78] The incentive to reduce, or increase, prices, given these conditions, will tend to vary depending on the relative size of the bank. For this reason, high levels of concentration can affect the incentive to compete intensely. As the ICB interim report noted:[79]

> For a small bank, setting a low price to attract switchers is more worthwhile than for larger banks since small banks can gain a greater proportion of their total customers by offering good deals. In addition, smaller banks lose less money on their existing customers by offering good deals as the existing customers are a smaller proportion of the existing and new customers together.

4.46 Large banks may, then, have a reduced incentive to compete for new customers relative to smaller banks, meaning that a more concentrated market structure, particularly in the presence of a large group of relatively inactive consumers, can reduce the competitive intensity of the market.[80]

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[77] See Paul Klemperer, 'Competition when Consumers have Switching Costs: An Overview with Applications to Industrial Organization, Macroeconomics, and International Trade', 1995, *Review of Economic Studies*, 62, pp515–539. Also S Sharpe, 'The Effect of Consumer Switching Costs on Prices: A Theory and its Application to the Bank Deposit Market', 1997, *Review of Industrial Organization*, 12, pp79–94. Switching costs are not the only potential source of market power. For example, strong preferences for a particular brand, or industry capacity constraints and barriers to entry, could also lead to market power.
[78] These may be new customers, both start-up SMEs with no existing bank relationship and established SMEs switching from another bank. Also relevant is additional demand which may come from a bank's existing customer base, by increasing their demand for the product in response to a lower price or better service.
[79] ICB Interim Report, April 2011, paragraph 2.50.
[80] Such a finding is consistent with Abbey National's submission to the CC, during the course of its investigation into the proposed merger between Lloyds TSB and Abbey National in 2001, in which it stated that: in markets 'with switching costs, firms with lower market share tended to grow (or "sow") their share by competing aggressively and through price, while those with high market share tended to exploit (or "harvest") theirs by preserving or increasing margins on the existing customer base', paragraph 5.113, p146, of the CC's report.

4.47 This particular concern about concentration in the presence of deterrents to switching is somewhat reduced when there is effective price discrimination. If banks can effectively price discriminate, then they may not be limited to setting the same price for all customers and choosing whether to lower this to attract new customers.[81] Large banks may, then, potentially have the same incentive to compete as smaller banks as they can both compete for new customers without this necessarily undermining the profitability of their current customers. In this regard, we observe that, in fact, banks do discriminate to some extent in their pricing to new customers relative to their existing customers through offering a period of 'free' banking for switchers and even longer periods of 'free' banking for start-ups.

4.48 One feature of the SME banking market is that there are a large number of businesses being created and a large number of businesses disappearing every year.[82] This, along with a (limited) degree of bank switching, leads to a high rate of churn for BCAs – a high proportion of a bank's customer base will change every year (see Chapter 8).

4.49 It is possible that the effect of having to acquire significant volumes of customers each year has a substantial impact on competition, by forcing even the largest banks to compete particularly intensely for new customers in order to prevent significant losses in market share. One bank argued that:[83]

> The depth and length of the investment by [the bank] and other banks in [pricing the transactional elements of the BCA offering below cost] for start-ups reflects the intensity of competition. This, combined with the high rate of business failures, means that [the bank] is highly incentivised to retain those start-ups which survive, in order to recoup its investment and obtain a return (given returns from customers during the start-up period are low).

This suggests that, while new-to-bank customers may not be very profitable to the bank in the short term, they may be profitable to the bank in the longer term if they remain in business and grow.

4.50 We recognise the force of these arguments and their relevance for the competition analysis in the specific and particular circumstances of this sector. However, we continue to have concerns about the effectiveness of competition in the presence of relatively high and stable market shares

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[81] Price discrimination arises when a bank can charge different prices to different customers for the same service. The pricing we consider here is the standard tariffs applying to a bank's BCAs.
[82] New businesses account for 10% of the stock of UK businesses each year. Source: ONS Business Demography, 2011, showing business birth rates in the UK, 2004–2011.
[83] Bank submission during the market study.

despite high levels of churn and lower pricing to start-ups and switchers. This is because, even in so far as there is more intense competition for new customers and switchers than for existing customers, it seems that the larger incumbent banks enjoy a number of advantages which may weaken the intensity of competition for new, and existing, customers. In particular, there is a strong propensity for start-ups to choose a BCA provider based on their choice of PCA provider, as we discuss above. This means that a major bank is likely to be able to count on obtaining a significant volume of business from its PCA customers, limiting, in turn, its incentives to compete as vigorously as it would otherwise do, in the absence of this significant advantage.[84] Moreover, another important factor in influencing an SME's choice of BCA provider is the location of the closest bank branch to the business (as we describe in Chapter 5). Therefore, the need to have a network of branches limits the degree to which smaller banks may attract new-to-market SMEs and this, in turn, may limit the intensity of competition for these SMEs.[85]

4.51 It is also possible that high concentration and stability of market shares are an outcome of certain demand side behaviour. As we will describe in later chapters, we have observed that SMEs are relatively inactive in terms of shopping around for BCAs and loans and in terms of considering switching provider. This behaviour gives rise to the major banks having a relatively stable base of business. This demand side behaviour means that competitive innovation, even by a larger bank, may have limited impact in terms of attracting new customers. This, in turn, is likely to weaken the incentives for banks to compete intensely.

4.52 However, we also recognise that, just as changes in demand side behaviour could stimulate the supply side, changes on the supply side may therefore also be an important element of stimulating the demand side. There is evidence that SMEs tend to feel that the current array of banks are largely all the same and, therefore, that there is little incentive to switch. The demand side behaviour described above may lead to large banks not seeking strongly to differentiate themselves from each other. The relatively stable supply side may therefore lead to disengagement on the demand side, as much as a disengaged demand side may lead to a relatively stable supply side. If there were even more differentiation between providers, including through, perhaps, new full-service providers with a strong commercial incentive to highlight the extent of their differentiation, then SMEs may be motivated to compare different banks' services. Therefore, the current structure and stability of the

[84] We have been told that providing PCAs is a prerequisite for SME customers. In this regard, it is noteworthy that there are no stand-alone business banks of any significant size.
[85] In Chapter 8 we provide additional reasons why we believe that churn and lower BCA pricing for start-ups and switchers do not ameliorate our competition concerns.

supply side of the market, along with the weak engagement of the demand side, may together lead to a softening of competition.

Effect of concentration – coordinated effects

4.53 In addition to affecting the incentives of an individual bank, concentration may lead the banks to have a greater realisation of the interdependence over time of their competitive conduct. This means that, even if a bank may have an incentive to cut its prices in the short term to gain customers, it may realise that this will be likely to engender a competitive response from its rivals which may cause the price decrease ultimately to be unprofitable. A common understanding across the banks of this interdependence may, then, lead to a less competitive outcome due to tacit coordination across banks on their competitive conduct. Indeed, such a concern about concentration increasing the likelihood of coordination lay behind the CC's decision to prohibit the proposed merger between Abbey National and Lloyds in 2001.

4.54 This common understanding, and the ability to come to a tacit common approach to competitive conduct, is considerably more likely to occur in a concentrated market (although other conditions are also required, particularly that there must be a high degree of transparency in the market to support coordination).[86]

4.55 The OFT last considered this issue in the context of its assessment of the proposed merger between Lloyds TSB and HBOS in 2008. After considering a number of features in relation to SME banking (as well as PCAs), the OFT concluded that the necessary conditions for the merger creating or strengthening the conditions for coordinated behaviour did not appear to be present for financial products sold to SMEs.[87] In this market study, we have seen no specific evidence indicating that the market has been characterised by coordination. Therefore, the current concentrated market structure and relatively stable market shares in SME banking are important market conditions which would support coordination, but are not alone sufficient to suggest that coordination is taking place.

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[86] The conditions for coordination are set down in more detail in the OFT's merger assessment of Lloyds/HBOS, paragraph 273. First, it must be possible for all firms in a market to reach the terms of coordination without any express agreement: there must therefore be a focal point for coordination and sufficient transparency that all firms can identify it. Second, coordinating firms in a market must be able to monitor deviations from the coordinated outcome: again, this requires that there be sufficient transparency to detect 'cheating'. Third, there must be a credible threat of retaliation to discipline firms deviating from the terms of coordination, such that fear of retaliation drives firms to coordinate in spite of incentives to deviate. Fourth, there must be insufficient constraints outside the coordination to defeat it (for example, entry must be hard and/or buyer power absent).
[87] OFT's merger assessment of Lloyds/HBOS, paragraph 301.

Conclusion on the implications of concentration

4.56 We recognise that there is no determinative link between concentration and a lack of competition. However, for the purposes of this Phase 1 market study, we believe there are reasonable grounds to consider that high and relatively stable market shares may contribute to a restriction of competition in the sector.

4.57 However, it is important to observe, as we suggest above, that concentration is often not a competition concern in itself. It is more likely to be a concern where there are barriers to entry and SME inertia, issues that we consider in detail in the following chapters. A lack of strong differentiation and weakened incentives to compete may also reinforce demand side weaknesses by reducing the benefits which SMEs believe there to be from engaging in search and considering switching. This, in turn, may feed back to weaken further the incentives of banks to innovate to differentiate themselves from each other.

Conclusions on concentration

4.58 Relatively high market concentration and, in particular, stable and high market shares over an extended period are often associated with poor market outcomes. Indeed, it is often a powerful indicator of competition problems even where it is not the cause of such problems.

4.59 In the supply of banking services to SMEs, particularly BCAs and business loans, the market shares of the largest banks have seen little change in the last four years, or even since 1999. There has been very limited organic growth by smaller banks, and each of the product and geographic markets remain concentrated, with the markets for the supply of business loans (by volume) tending to be even more concentrated than BCA markets. An important explanation for the similarities we have observed in relation to market structure between BCAs and business loans appears to reflect the significant importance of BCAs as a ‘gateway product’, which appears relevant both to business loans and to a wider range of other SME banking products.

5. Market structure: entry, expansion and exit

Key facts and findings:

- Although there has been recent entry into some specialist niches, only one new BCA provider (Metro Bank) has entered the market in recent years.
- There have been important initiatives in relation to improving access to information on creditworthiness and new bank authorisation which are likely to reduce some barriers to entry and expansion.
- However, significant barriers to entry and expansion remain: despite substantially increased usage of online and mobile banking, and reduced usage of branches, branches are still valued by most SMEs, so that a network of local branches still seems necessary to be a significant competitor in the sector; and concerns have been expressed to us about the cost and difficulty for smaller and newer banks to gain access to payment systems which are key to offering BCAs.
- As new entry or potential new entry is one of the key competitive constraints encouraging existing providers to compete on price, service and innovation, such barriers result in a reduced incentive on the largest banks to compete.
- The situation is made worse by low switching rates and customer inertia (set out in more detail below), with the result that there are insufficient numbers of profitable customers that are sufficiently easy for smaller and newer providers to acquire.

Introduction

5.1 In the preceding chapter we considered the structure of the markets for the focal products. We concluded that the market shares of the largest banks have remained relatively stable across an extended period of time. In this section we consider:

- first, the nature of the entry and expansion we have observed in the sector in recent years and what that may tell us about the intensity of competition in the sector
- second, the nature and extent of any barriers to entry and expansion we observe in these markets, including any recent or forthcoming changes

5.2 In conducting the market study, we have engaged with smaller and newer providers of banking services to SMEs, including both banks and alternative financial service providers, to find out their views on any barriers to entry and expansion they face. This chapter reflects the information we have received from these parties, as well as our general analysis of SME banking.

Actual entry, expansion and exit

5.3 Despite the limited changes we have observed in market structure over the last decade, we have seen some evidence of entry from various providers in recent years. This entry falls into three general categories:

- entry and expansion by smaller providers, seeking to provide a full (or at least a broad) range of banking services to SMEs
- entry and expansion by smaller providers, providing a limited range of banking services to SMEs
- entry by alternative providers of financial services for SMEs

5.4 We have also observed exit by certain providers.

5.5 Our focus on this section is on the growth of smaller and newer providers, reflecting our findings in Chapter 4 about the relative stability of market shares. However, we do note, from our review of the banks' internal documents, that each of the largest banks do appear to have particular ambitions to develop their SME banking presence. These ambitions, however, at this stage do not seem to have led to significant changes in market structure.

Entry and expansion by smaller full-service providers

5.6 The most significant development in the market for liquidity management services is the emergence of the Santander brand. This does not constitute entirely new entry, but rather it reflects a merger of existing retail banks as a result of Santander's acquisitions, between 2004 and 2010, of Abbey National, Alliance & Leicester and Bradford and Bingley, the first two of which were identified as significant 'challenger' banks by the OFT in 2007.[88] By 2010, as we mention in Chapter 4, Santander's share of main banking relationships had grown to 10%, compared with the combined market share of Abbey National and Alliance & Leicester of 7% in 2005. However, since 2010 Santander's market share appears to have stabilised.[89]

5.7 Santander is, in many respects, an effective competitor to each of the major banks, with an established customer base, extensive experience in the provision of banking services and a well-established distribution network. Moreover, we are well aware of the significant investments that Santander has

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[88] OFT (2007) considered three 'challenger' banks: HBOS, Alliance & Leicester and Abbey National. These three were considered to have 'the potential to expand and challenge the four main banks in England and Wales'.
[89] OFT (2007), p28, and Charterhouse data for the years ended Q2 2010, 2011 and 2013 and for Q3 2013.

made to develop further its proposition to SMEs. In a short space of time Santander has particularly increased the number of relationship managers employed, investments in its IT products and increased the number and sophistication of products offered. This investment has been delivered to enable Santander to compete in the established, growing and larger SME market where full service business needs are in greater demand. Santander has continued investment underway to enhance the breadth of its proposition, meaning:

- Much like Abbey National and Alliance & Leicester before, it continues to support and service smaller SMEs which will typically generate lower revenues,[90] as demonstrated by our analysis of BCA shares of supply by turnover.

- Santander's market presence in relation to business loans is growing as its SME proposition expands. However, this is partially limited by the size of many of its customers, which are too small to have a significant lending requirement.

5.8 However, we note, as set out in Chapter 4, Santander's growth in BCAs in recent years has been reasonably limited and its share of business loans is comparatively very low. Notwithstanding the investments outlined above, it is therefore unclear that it is significantly constraining the activities of the largest banks across the full range of SME customers and products at the current time.

5.9 Turning to smaller banks, we note the entry by Metro Bank and the continued expansion by Handelsbanken, albeit focused on particular customer types:

- Metro Bank opened its first branch in 2010 and now operates over 25 branches across London and south-east England, with an ambition to have 200 branches by 2012. It has reported rapid growth, doubling its personal and business customer numbers in 2013 to 275,000.[91]

- Handelsbanken has a recently expanded network of over 160 branches serving personal and corporate customers.[92] It provides a branch-based relationship banking model which devolves decision-making to the managers of individual branches and targets particular SME customer

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[90] OFT (2007). However, in 2007, the OFT felt that there were signs that Alliance & Leicester, in particular, was attempting to expand its medium-sized business customer base.
[91] www.metrobankonline.co.uk/News-Events/PressReleases/2014/January/Metro-Bank-reports-record-growth/article/.
[92] Handelsbanken's 2013 annual report. The bank has demonstrated a steady increase in the number of branches it operates, opening 28 in 2013 and 29 in 2012 (see the 2012 and 2013 Handelsbanken annual reports).

groups; these include medium-sized SMEs, professionals and other customers seeking a personalised and bespoke service.

5.10 We consider these entries to be encouraging developments. However, their role in each of the markets we have focused upon during the market study remains very limited, both individually and in aggregate. Indeed, neither of those banks appears to account for more than 1% of the share of main banking relationships in any of the three geographic markets which we consider.[93] We have also seen an internal corporate strategy document from one large bank that notes that Handelsbanken has had only a 'limited impact'. Moreover, we note that while Metro Bank and Handelsbanken offer a full service proposition, their product range remains somewhat more limited than the largest UK banks, despite both of these banks seeking to expand this.[94]

5.11 We are also aware of at least one other provider, Atom, which is seeking to offer a broader range of banking services, and with whom we have consulted during the market study. However, Atom is currently at a very early stage of obtaining authorisation, such that it is not possible to say what, at this stage, its impact will be.

5.12 On the basis of the above, we therefore note that despite evidence of some entry and expansion, and some growth by certain providers, we see no evidence that the newer providers represent a real scale threat to the largest banks.

Entry and expansion by limited-service providers

5.13 Various other providers have entered and expanded in SME banking markets in recent years, focusing on serving particular niches, by reference to product or geographic area. For example:

- Aldermore, which was launched in 2009, claims to be the 'fastest growing bank in the UK'. It operates without a high-street branch network and specialises in lending through commercial mortgages, invoice finance and asset finance.[95]

- Shawbrook, a provider of specialist lending products. We understand that it focuses on developing relationships with its customers by providing

[93] The market share data we have from Charterhouse does not show Handelsbanken and Metro Bank and, therefore, we believe that their market share is likely to be less than 1%.
[94] For example, it appears that Metro Bank has only recently begun to offer invoice discounting services through its purchase of SME Invoice Finance in the summer of 2013.
[95] See Aldermore website.

lending either through brokers or directly with the customer and under-writing the majority of its lending products.

- Cambridge and Counties received its banking authorisation in June 2012 and currently offers savings accounts, commercial property and residential investment loans and secured pension lending. Owned by Trinity Hall, Cambridge and Cambridgeshire Local Government Pension Fund, the bank was originally created to support SMEs in the local area although has recently unveiled plans to expand into the West Midlands and North of England.[96]

- Close Brothers provides asset finance, invoice finance, premium finance business, motor finance to retail customers, point-of-sale car finance and property development lending to SMEs.

- Paragon is a specialist lender of buy-to-let mortgages to landlords and residential property investors in the UK, and obtained its banking authorisation in February 2014.

5.14 These providers operate in limited areas, rather than competing more generally with the full-service providers, and do not offer a BCA, meaning that they do not obtain the 'gateway' benefits which we describe in Chapter 4. Moreover, these providers, and those like them, are typically focused on developing service offerings and products to meet gaps in the full-service bank's propositions, particularly more profitable gaps. Indeed, one such provider told us that the reason that it had been able to grow in recent years was because of the contraction in lending at the largest banks; it expressed concern that once the major UK banks returned to lending, it would be very difficult for it continue to grow.

5.15 Moreover, we note that none of these providers has anything other than a negligible market share in relation to any of the product or geographic markets we have considered. Indeed, as we discuss in later chapters, we see that customer awareness of these alternatives appears very low.

5.16 In our assessment, these characteristics may indicate that these smaller providers currently impose only a limited competitive constraint on the larger banks.

[96] See Cambridge and Counties press releases of 20/02/2014 and 22/05/2014.

Entry by alternative providers of financial services

5.17 There has also been entry and expansion in recent years from non-bank providers of financial services. This includes providers of asset and invoice finance as well as companies offering alternative lending platforms, most notably peer-to-peer finance companies. These providers include:

- Funding Circle, which operates a peer-to-peer lending platform, established in 2010. The platform matches investors seeking returns to businesses seeking finance.

- Market Invoice and Platform Black, which both operate an online platform where businesses can access the capital tied up in their invoices by selling them via auction.

5.18 We recognise that these forms of lending play an important but currently limited role in providing finance to SMEs. Indeed, greater awareness and use of these other forms of finance may provide increased competitive pressure on the pricing and other terms of more traditional SME financing. However, this effect is likely to be limited in the short term given the relatively low awareness and use of alternative sources of finance.

5.19 We also recognise that other types of providers may provide an alternative financial service for SMEs in particular areas, particularly PayPal in relation to payments. However, again, we have seen no evidence that these play any more than a limited role in providing financial services to SMEs at the current time. Moreover, given the significant functional differences between BCAs and PayPal, we do not consider that they are likely to be alternatives from an SME perspective.

Exit from the market

5.20 In addition to entry and expansion, following the financial crisis there also appear to have been some providers exiting the market, principally a number of smaller providers that were active in supplying banking services to SMEs, including certain providers based in the Republic of Ireland. This exit has been particularly pronounced in relation to commercial mortgages, but has also been experienced in relation to other products (albeit only to a very limited extent in business loans), as shown in Table 5.1 below.

TABLE 5.1 **Number of providers of SME banking services***

	2007	*2008*	*2009*	*2010*
Commercial mortgages	75	72	45	39
Bank business loans	20	20	17	18
Remortgages – for business purposes	38	28	16	14
Total	133	120	78	71

Source: Business Finance Taskforce (2010)

*The figures from this report are, in turn, sourced from Moneyfacts. The figures presented in the table above are those from the second half of each year shown.

5.21 With the exception of Bank of Scotland, it is unclear that these providers were likely to provide a significant general competitive constraint on the largest banks, given their particular focus on property-based lending. However, to the extent that these providers did, collectively, place a significant competitive constraint on larger incumbent banks, the scale of exit between 2007 and 2010 would be expected to reduce competitive constraints on remaining providers.[97]

Conclusions on actual entry, expansion and exit

5.22 The evidence presented above indicates that while there have been some encouraging developments, entry and expansion in SME banking has remained very limited in recent years and many more providers have exited the sector than have entered it.

5.23 Where entry has occurred it has predominantly been by smaller, niche market participants, typically providing a very limited product range and focusing upon the most profitable customers. We have seen very little evidence that these smaller banks constitute any more than a very limited constraint on the behaviour of the largest UK banks.

Barriers to entry and expansion

5.24 Barriers to entry and expansion can be defined as obstacles that increase the difficulty of a firm entering or expanding in a particular market. The CMA’s Market Guidelines class barriers to entry into three broad categories, namely a ‘natural’ feature of the market, such as the capital costs required for entry and economies of scale, or strategic advantages of incumbents which increase the risks new entrants face, or those created by the regulatory environment.

[97] It may be that some of the apparent exits are explained by mergers, eliminating at least one of the brands. This may mean that some of the pre-merger assets remain in the market, meaning that the apparent exit would not necessarily imply a reduction in competition.

5.25 When barriers to entry and expansion are high, incumbents' profits and position in the market cannot easily be threatened by newer and smaller providers. This, in turn, will lead to incumbents' incentives for innovation and greater efficiencies being reduced with customers potentially facing higher prices, lower quality and a narrower range of products or services than they could otherwise benefit from. In all cases, what is important is not so much whether there are barriers to entry and expansion, but rather whether potential entrants and existing firms are able to overcome them to be able to compete effectively in the market.

5.26 There have been long-standing concerns about significant barriers to entry and expansion in the market for SME banking services, expressed by the CC inquiry and the OFT in 2010. We have sought in this section to update that previous analysis.

5.27 Table 5.2 sets out each of the potential barriers to entry and expansion which we have considered, highlighting whether we have considered them in the context of barriers to entry and/or expansion, and which of the focal products we consider them to be most relevant to. These are then considered in turn in the remainder of the chapter.

5.28 However, before we consider these barriers individually, and by way of summary, we consider that customer inertia and low rates of switching act as particularly significant barriers to entry in this sector by making it difficult for newer and smaller customers to acquire customers. Moreover, we note that notwithstanding the growth of online and mobile banking, the need for an extensive network of local branches remains, which can be costly for newer or smaller providers to acquire. Moreover, we have heard continued concerns about access to payment systems by newer and smaller banks during the study and about the effect of capital requirements, again making entry and expansion difficult.

TABLE 5.2 **Overview of the potential barriers to entry and expansion and our approach to them during this chapter**

	Whether we consider it as a barrier to entry or expansion or both	*Whether it is relevant to liquidity management services*	*Whether it is relevant to business loans*
Regulatory requirements and processes			
Authorisation	Entry	X	
Capital and liquidity requirements	Both	X	X
Key inputs or requirements to develop an SME banking business			
IT systems	Both	X	X
Access to payment systems	Both	X	
Access to key creditworthiness information	Both		X
Obtaining financing	Both	X	X
Distribution of products: a need for an extensive branch network	Expansion	X	X
SME behaviours and preferences	Both	X	X
Behaviour of incumbent banks			
Waivers and deeds of priority	Expansion		X
Bundling	Expansion		X
Price discrimination	Both	X	
Restriction on banking services	Entry		X

Source: CMA.

Regulatory requirements and processes

5.29 The activities of retail banks are regulated to maintain the stability of the banking system and to protect consumers. In order for an institution to provide banking services it must meet a range of requirements. In particular, in order to carry out most retail banking activities, retail banking providers must obtain authorisation from the appropriate regulatory authority, as well as meet certain capital and liquidity requirements, and consumer protection requirements.[98]

5.30 These regulatory requirements can act as a potential barrier to entry and, in many cases, it is entirely appropriate they do so. For example, rules preventing firms which are inadequately capitalised, insufficiently liquid or run by unfit individuals from becoming deposit takers are essential to protect depositors and maintain confidence in the banking system.

5.31 Nonetheless, regulation should strike the right balance between achieving these aims and ensuring that competent firms are not unduly hindered from entering and expanding in the market. Regulations or regulatory processes that unnecessarily prevent or delay the entry of competent new operators to the market may increase barriers to entry, with a potential detrimental impact

[98] See the FCA website for further information on regulatory requirements for the providers of banking services.

on the price, quality and range of products available to consumers through more limited competition.[99]

Obtaining authorisation

5.32 A firm that wishes to accept deposits in the UK must be authorised by the PRA (with the consent of the FCA).[100] Authorisation can be obtained by:[101]

- applying for a new authorisation (a de novo application)
- seeking a variation of the permissions of an existing regulated firm to add deposit-taking activities
- applying for a change in ownership of an existing regulated firm that currently holds an authorisation, usually referred to as a 'change in control'

5.33 The OFT in 2010 identified that the authorisation process could be unclear and uncertain to new banks wishing to enter the market.[102] The FSA and the Bank of England have since conducted a review of the authorisation process in 2013. As a result of that review, the authorisation process has been amended to make it quicker and more cost effective for firms. There has also been a major shift in the approach to the prudential regulation of banking start-ups through a reduction in the capital requirements at authorisation and reductions in liquidity requirements for all new banks. The changes were implemented by the FSA's successor bodies the PRA and the FCA.

5.34 With respect to the authorisation process, the PRA and FCA now offer significant upfront support to firms before they apply for authorisation to help them submit a better quality application (pre-application stage). Both regulators also seek to take a proportionate and pragmatic approach to the way in which an application is assessed and information is required. Moreover, the authorisations process now includes an optional mobilisation stage; this reflects the fact that some applicants found it difficult, without the assurance of being authorised, to raise all the required initial capital, invest in IT systems and hire key staff. Under the mobilisation option a new bank is authorised to accept deposits, albeit with restrictions on the business that it

[99] In addition to obtaining authorisation, and capital and liquidity requirements, which we consider in this section, we also note the announcement in March 2014 of the FCA's regulatory approach to crowd funding (including peer-to-peer platforms). In producing that approach, careful consideration was given to facilitating competition, while providing protection to consumers. We note that the Peer to Peer Finance Association has welcomed the FCA's approach as 'proportionate … in line with its competition and consumer protection objectives'.
[100] Under EU single market rules, an authorised deposit-taker in the EEA does not need to be authorised by the PRA but can accept deposits through branches in the UK if it has been issued a 'passport' under the Banking Directive from its home state regulator and the PRA.
[101] Under the current process both the FCA and the PRA must consent to the authorisation of the applicant.
[102] OFT (2010), *Barriers to Entry*, paragraphs 5.30–5.33.

can undertake, while it builds out the remaining requirements such as capital and IT.

5.35 During the market study we have been informed that reactions to the revised authorisation process have been positive. In the 12 months to end March this year there have been pre-application discussions with over 25 potential applicants. Since the original review of requirements for firms entering or expanding into the banking sector was published in 2013 there has been a marked increase in the number of firms in pre-application discussion with both the FCA and the PRA. These firms have a range of different business models from wholesale banking to FCA-regulated payment services firms which are looking to enter the banking market and offer deposits and lending to their current client base (including SMEs) to others who are proposing to offer a mixture of SME or mortgage lending funded by retail and SME deposits. Of those banks currently going through the pre-application process which have indicated plans to provide SME banking services, this appears to be predominantly limited to specialist lending products.

5.36 This positive reaction has largely been confirmed in various discussions we have had with parties with direct experience of the authorisation process in recent years:

- One bank which has recently completed the authorisation process provided positive feedback on the experience, particularly the level of engagement it had with the FCA/PRA during the process.

- One company, which provides advice to those considering making an application for authorisation, and which has been historically critical of the authorisation process, has provided positive feedback that the changes to the authorisation process have made achieving authorisation easier. Other banks also commented to us that, in their experience, the authorisation process seems to have been improved and is now easier than they believed it would be.

- However, one party did express continued frustration with the authorisation process, noting that, in its experience, it was costly and had taken considerable time.

5.37 An update on progress one year on was published by the PRA and FCA on 7 July 2014.[103] From this update, there continues to be no evidence to suggest that either regulators' high-level standards, or the FCA's conduct of

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[103] FCA/PRA (2014), A review of the requirements for firms entering into or expanding in the banking sector – one year on.

business requirements, are disproportionate or pose excessive barriers to entry or expansion in the banking market.

5.38 We do, however, recognise that whilst the changes to the authorisation regime have been well received, and the PRA and FCA continue to adopt a pragmatic and proportionate approach,[104] it is still too early to come to any definitive conclusion on the longer-term impact on competition from these changes to the authorisation process.

Capital and liquidity requirements

5.39 Rules on capital and liquidity are designed to help protect savers and investors from the risk of failure or bankruptcy of financial institutions, and ultimately the losses associated with these risks when they are realised. In general, these rules require deposit-takers to hold: an amount of capital above the level that firms may privately choose; and a proportion of their assets in a sufficiently liquid form to help ensure they can meet their commitments even in the case of financial and economic stress.[105] Capital adequacy rules set out the amount and type of capital a deposit-taker must hold, which is based on the riskiness of the assets they hold. Liquidity requirements specify the proportion of unencumbered high-quality liquid assets that must be held in a form, such as short-term government securities, that can quickly be converted to cash to meet their liquidity needs.[106] The requirements are calculated in relation to the size of a deposit-taker's liabilities.

5.40 Prudent deposit-takers will, as part of their internal risk management processes, determine the level of capital that they need to hold in order to continue trading under a wide range of scenarios, including situations of financial stress. However, given the systemic risk that a bank may pose to the wider economy and the implicit government guarantee many banks receive for being 'too big to fail' or 'too connected to fail',[107] the PRA imposes minimum capital and liquidity standards, which themselves are often mandated by international agreements.

5.41 Notwithstanding the importance of these activities, which are known as prudential regulation, concerns were raised by the ICB report in 2011 that the existing prudential regulations may have adverse effects on competition,

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[104] Such as enhancing the information provided to firms during the pre-application and mobilisation stages.
[105] In this study, we focus on the requirements facing deposit-takers. However, capital requirements also apply to insurers, broker–dealers and mortgage lenders.
[106] This is not the same as market liquidity, which relates to the volume of trading of an asset in the market and the ease with which the asset can be bought or sold without affecting its price.
[107] Banks may benefit from this implicit government guarantee even if they are not 'big' as their failure may cascade through the financial sector causing a systemic failure.

particularly by increasing the burdens which smaller banks may face, relative to larger established banks.[108]

Regulatory responses on capital and liquidity requirements

5.42 The PRA is well aware of these concerns and has taken specific action since 2013 to reduce the impact of regulatory capital and liquidity requirements on the ability of banks to enter and expand their businesses. These have included, as mentioned briefly above, removing additional capital and liquidity requirements on new banks, including:

- removing additional requirements (known as 'scalars' and 'add ons') which were previously applied to new banks to reflect the inherent uncertainty associated with them, which had resulted in these banks having higher capital requirements than existing banks and deterred new entry
- removing the automatic new bank liquidity premium and reducing liquidity requirements from those applied to existing banks

5.43 Moreover, the PRA and FCA in their update on progress one year on noted that:

- The PRA has recently implemented a specific regime for the authorisation of 'small specialist banks', which include those which lend to SMEs. For such banks, authorisation may be granted where they maintain capital resources equal to or above a base capital requirement of whichever the higher of £1 million or €1 million plus capital planning buffer, rather than the previous capital requirement of €5 million plus capital planning buffer.
- The PRA will conduct a supervisory review and evaluation process for new entrant banks on a yearly basis rather than, as currently, at the 12-, 36- and 60-month stage. This is to ensure that a new bank's capital requirements better reflect its balance sheet on an ongoing basis and reduce the risk that the capital requirements are disproportionate such as to inhibit expansion.

5.44 Finally the PRA, following the implementation of the Banking Reform Act, now has an explicit secondary objective to facilitate competition. As a secondary objective, the requirement to facilitate competition is subordinate to its general objective to promote the safety and soundness of the firms that it regulates.[109] This means that in taking actions which advance the PRA's primary objective,

[108] The ICB report, paragraphs 7.25–7.32.
[109] And a specific objective it holds in relation to the insurance sector.

it will be expected to act in a way which advances its competition objective. More broadly, the PRA must and will be mindful of the likely competition effects of its actions. The PRA is undertaking a programme of work to ensure that this new objective is reflected in its decision-making. It is also taking forward projects reviewing parts of the prudential framework enabling it to consider changes to its approach that might further its competition objective without undermining the general objective.[110] The PRA's 2014 annual report reiterated the commitment to undertake to begin periodic review of existing rules to identify areas where changes would facilitate greater competition without compromising the safety and soundness objective.[111]

Findings on capital and liquidity requirements

5.45 During the market study, we have heard no specific concerns that capital requirements have acted as a barrier to entry, perhaps reflecting the various initiatives highlighted above, which particularly focus on the smaller banks.

5.46 However, we have heard various concerns that capital requirements have impacted on the ability of smaller banks to compete effectively, such that they can effectively and profitably expand their general SME lending business. For example:

- One small bank has submitted that it must hold proportionally between five and seven times the capital which its largest competitors must hold, increasing its funding costs above those of larger competitors and limiting its ability to compete

- Another small bank made a similar submission, highlighting the significant differential it considers that it faces in required capital holdings, compared with its largest competitors

- One bank indicated that the effect of differential capital requirements between itself and the largest banks meant that it was more likely to focus its business in specific areas where potential margins were somewhat greater, so as to counterbalance the increased capital costs that it faces

5.47 In particular, we have been informed that, in general, larger, established banks tend to use different methodologies than smaller banks to calculate their required capital holdings:

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[110] See The Prudential Regulation Authority's approach to banking supervision, June 2014.
[111] PRA 2014 annual report, p25.

- Established banks can use an 'internal ratings based' (IRB) model to determine their capital requirements. This model uses the lender's own estimates of the probability of default to calculate the risk weights to be applied to loans where they have been given permission to do so.[112]

- Newer banks rely on the 'standardised approach',[113] under which risk weights are determined by European legislation and either based on external credit ratings assigned to the borrower or, for borrowers without a formal credit rating, fixed at 100%.

5.48 On a like-for-like basis, as the ICB report noted,[114] the IRB approach is likely to lead to lower regulatory capital requirements than the standardised approach, leading to smaller banks generally facing more onerous, proportionate capital requirements than others. However, it is also important to note that capital requirements for small, undiversified lenders will usually be constrained by an overall floor, whereas this is unlikely to be the case for diversified universal banks.

5.49 During the market study, and consistent with views expressed above, we have heard that the capital requirements arising from having to use the standardised approach may mean that smaller and newer providers may need to put up proportionately more capital than banks using the IRB approach. This means that they often focus only on profitable, niche areas of lending, rather than offering a more general proposition.

5.50 This is consistent with BBA research that, in general, indicates that the impact of the usage of the IRB and standardised approaches can have significantly different impacts on banks' required capital holdings depending upon the nature of the product offered:

- For 'safe' lending, such as mortgages, an IRB bank can put up just 30 to 40% of the capital of those banks using the standardised approach

- For 'riskier' lending, such as unsecured lending, the difference in capital requirements is much less (or non-existent).

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[112] Values for loss given default, exposure at default and maturity of exposure are then assessed. For those banks with advanced IRB status, this is completed by the banks themselves. For those with 'foundation' IRB status, this is established by the PRA. It should also be noted that, while a bank may have IRB status, it may still be required to use the standardised approach where it cannot demonstrate that its models meet regulatory standards.
[113] Not all banks can use an IRB model as the bank needs to have several years' worth of data and risk assessments. IRB approaches are likely to lead to lower capital requirements than with the standardised approach. (Source: OFT (2010) Barriers to Entry.)
[114] The ICB report, paragraph 7.29.

This tends to mean that smaller and newer banks, using the standardised approach, are less able to compete for 'safe lending', but instead focus in specific areas where they may be at less of a capital disadvantage,[115] limiting their ability to develop a more general proposition.

5.51 While we understand that, in principle, there is not a regulatory restriction limiting the use of the IRB model to larger established banks, we understand that smaller banks often lack the data, systems and specialist staff to employ this methodology in practice. This is consistent with the PRA's comments to us during the market study and publicly that the costs and conditions of becoming a bank which uses an IRB model can be 'considerable' and 'may cause competitive distortions to banks undertaking similar business under the IRB approach'. We note, however, that the PRA is committed to 'actively to engage with … small banks prepared to put in the necessary work to move to the IRB approach to the calculation of its credit risk'.[116]

Conclusions on capital and liquidity requirements

5.52 We recognise that effective prudential regulation is critical to the safety and soundness of the firms which are regulated, and that inevitably this will result in the imposition of requirements on firms, which will restrict their commercial activities, particularly on smaller firms whose resilience may be more limited; indeed, it may often be important that they do so. Moreover, we also recognise that prudential standards are set primarily at an international level, with at most limited discretion on the part of national regulators to make alterations to achieve competition objectives.

5.53 Notwithstanding these limitations, we welcome the steps taken to date to reduce the effect of capital requirements and liquidity requirements as a barrier to entry.

5.54 However, potential concerns still appear to arise from the impact of differentials in the assessment of capital requirements on the ability of smaller banks to grow and develop their lending business.

Key inputs and requirements to develop an SME banking business

5.55 To offer retail banking products competitively, providers need:

- access to appropriate means to distribute their products

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[115] BBA (2014), p67.
[116] FSA/BoE (2013), A review of requirements for firms entering into or expanding in the banking sector, p9–10.

- appropriate infrastructure, such as IT systems, to process transactions and comply with risk management processes
- to allow their customers access to industry-wide payment schemes
- to be able to determine accurately potential customers' risk profiles
- access to finance to fund operations

5.56 If providers are restricted from accessing all these inputs, the likelihood of them being an effective competitor will be limited.

5.57 In addition, given the costs of these inputs, banks will have other requirements in order to be an effective competitor. These include the need to attract sufficient numbers of profitable customers to be able to recoup the necessary investment, including effective access to distribution arrangements in order to market products and the ability to effectively acquire customers.

5.58 This section will consider each of these inputs and requirements, and their availability and cost to new entrants.

Access to appropriate means to distribute their products

5.59 In order to be an effective competitor in the provision of SME banking services, a provider will require an efficient means to distribute its products to SME customers. Historically, this has required banking providers to have a physical presence, predominantly through a network of local branches to provide SME banking services.

5.60 Various previous studies have highlighted that the requirement to have such a network of branches constitutes a significant barrier to entry and expansion, given the significant costs associated with establishing and maintaining them.

5.61 However, in recent years, alternative means to access banking systems through direct electronic means have emerged and grown significantly. In this section, we consider the extent to which a smaller and newer provider requires a branch network in order to be an effective competitor in the provision of SME banking services.

The continued relevance of local branches

5.62 During the study, we have considered the extent to which SMEs continue to use and value branches, which gives a strong indication of how important it is for a provider to have in place a local branch network.

5.63 It is clear that there has recently been a huge increase in the usage of banking methods other than through branches, in particular through online and mobile banking methods. This seems to have led to a decline in the volume of usage of branches for transactions. However, it does not follow that SMEs no longer require their banks to have sufficiently extensive branch networks to provide local branches. Indeed, the evidence we consider below suggests that branches remain important,[117] both to:

- acquire SME customers in the first place
- to then provide services to those customers

5.64 In particular, survey evidence indicates the following:

- In a survey carried out by YouGov, 30% of new businesses would rate 'convenient branch location' as an important or very important factor when choosing a new bank[118]
- In a different survey of SMEs carried out by Datamonitor, 61% of SMEs indicated that it was important or very important to have a bank branch near their office[119]
- Charterhouse data shows that 81% of SMEs used their bank's branch counter service[120]
- BBA-commissioned survey research shows that only 14% of SMEs never use branches, with 47% of SMEs using a branch at least monthly. Moreover, the same survey found that 68% of the SMEs surveyed agreed that 'having a local branch is important'; 65% of surveyed SMEs also found branches to be necessary when they needed to discuss issues 'face to face'. On the basis of this research, the BBA considered that branches remained 'necessary', albeit they were not needed 'everywhere'.[121]

5.65 This is consistent with many of the submissions we have received during the market study, which also appear to demonstrate the importance of branches

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[117] We also note that Bancology, a consultancy, in reviewing the trend in opening and closing branches in the USA, notes that alternate channels are reducing consumers' dependence on branches for routine payments. However, branches remain the predominant channel for account opening as well as an important means of reinforcing the institution's convenience and availability. Bancology also finds that the closure of branches has stabilised following the financial crisis. We refer to this by way of analogy to inform our understanding of the position in the UK, while recognising that there may be different dynamics in local banking between the banking sectors in the UK and the USA.
[118] YouGov (2013) finds that 42% of micro SMEs (under £100,000 turnover), 33% of small SMEs (£100,000 to £999,999 turnover) and 31% of medium SMEs (over £1 million turnover) would rate 'convenient branch location' as important or very important (CMA analysis of YouGov (2013) survey).
[119] Datamonitor (2012), slide 27.
[120] Charterhouse, Q3, 2013.
[121] BBA (2014), pp32–34.

in the relationship between SMEs and their banks. In particular, we have heard the following:

- Many small and cash-handling SMEs businesses are reliant on local branches
- Certain smaller banks have also indicated that not having a branch (or business centre) near to SME customers can be a limiting factor in attracting new custom
- Specifically, it was highlighted that most BCAs are opened in larger, higher footfall branches[122]

5.66 We also note that in Scotland and Northern Ireland, there has been limited expansion by HSBC and Barclays, which clearly have access to all of the other key inputs required to provide banking services for SMEs, other than a branch network. While there may, of course, be other reasons for this limited growth by these banks, the absence of a physical branch network is likely to be a contributing factor to this.

5.67 Beyond the direct effect of an extensive branch network on a bank's ability to compete in the supply of PCAs and/or SMEs, we have also been told that having a branch network can have other competitive benefits, such as reassuring potential customers of a bank's financial strength[123] and enabling a bank to attract funding, through low-cost cash deposits.[124]

5.68 Some respondents also stressed that local presence, in either branch or business centre form, was not simply important for cash handling, but also for understanding local markets.[125]

Alternative physical means to distribute banking services

5.69 We have been informed of various alternative means for a bank to have a physical presence in a particular geographical area.[126] These include:

- Setting up regional centres in which relationship managers are based. In this regard, we have also heard from banks that the opening of business or corporate banking centres is common and becoming a successful

[122] Statements in this paragraph are taken from meetings with various parties during the market study.
[123] BDRC focus group research found that SMEs, when choosing a bank, take into consideration its financial strength, albeit to a lesser extent than other factors (slides 33 and 80).
[124] Meetings with two smaller and newer banks.
[125] Meetings with two smaller and newer banks.
[126] In addition to these, a prospective entrant may also use an existing retail distribution network for the supply of other products, for example Tesco's position in relation to PCAs.

alternative to branches and has led to significant gains in new business customers.[127]

- Using the facilities offered by another bank, using what are termed Inter-Bank Agency Agreements (IBAAs),[128] which enable a bank to use another bank's physical facilities, for certain services.

- Usage of the Post Office network.[129]

5.70 While such mechanisms reduce the requirements for a bank to establish a physical presence, it is noteworthy that the smaller and newer providers, such as Metro Bank or Handelsbanken, have not sought to rely entirely on these mechanisms. We understand that this reflects the benefits of building an appropriate branch network. Moreover, among the largest banks, many of which are contracting their branch networks, we note that none has engaged in a large-scale branch closure programme to reduce branch numbers to a minimal level, indicating that branches continue to provide benefits to those banks. Indeed, one of the largest banks indicated to us that, notwithstanding any closures being undertaken, there would still be a need for a very considerable 'core' local branch network.

5.71 Moreover, we understand that there are significant limitations with each of the mechanisms above:

- Regional centres are unable effectively and conveniently to address SME needs for cash handling.

- IBAAs, while used by some providers, are not well known to customers.[130] It is also not possible for in-branch relationship services to be provided in this manner. Historically, smaller banks also appear to have seen IBAAs as an inferior means to serve customers because it gives the other bank's branch an opportunity to sell other products to the customer, or ultimately to encourage the customer to switch to them.[131]

- We have been informed that the ability of the Post Office to attract SMEs is limited as a result of low awareness of the Post Office's business banking

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[127] Meeting with smaller and newer banks. Indeed, the OFT noted that in its advice to the Chancellor of the Exchequer with respect to divestments that W&G would have the 'ability to compete to attract customers for its wide range of SME products and services without the need for a local branch since it has a range of SME centres with trained staff to support the needs of most SME customers across the UK'.
[128] IBAAs are arrangements between banks to provide a range of branch counter services to another bank's customers by prior arrangement.
[129] In this regard, we note RBS's announcement that it will expand the range of services available to SMEs at Post Offices during 2014.
[130] With respect to awareness of IBAAs, see the Campaign for Community Banking Services.
[131] OFT (2007), paragraph 4.117.

services, differences between the bank and post office branch environment and limited capabilities and service offerings in some post offices. We have also seen some evidence from one party indicating that SMEs prefer to use bank branches rather than counter services at the Post Office. One source, which has explored using this service, indicated that there had been challenges in obtaining agreement with the Post Office on this issue. Moreover, such a method would also not facilitate the provision of in-branch relationship services.

5.72 While these methods could therefore be of assistance to newer or smaller banks in particular circumstances, it is unlikely that they could provide a full substitute to the local branch networks available to the major providers of banking services. In particular, none of these options offers the same mix of relationship and cash-handling facilities which are required by a large number of SMEs.

5.73 That being the case, we note that the establishment of branch networks may be costly for newer or smaller providers. This is consistent with evidence we have seen that for Handelsbanken the average cost to open a branch in one of its regions (outside London) is [✂] per branch in respect of fit-out costs, IT, staff and rent. We also understand that branch-opening costs for [✂] are also considerable, [✂].

Alternative direct means to distribute banking services

5.74 Nevertheless, we recognise that alternative banking channels are becoming increasingly important as more SMEs are using alternative means to access their bank, particularly using online means for at least some transactions. Datamonitor, for example, shows that 89% of SMEs view Internet banking as important.[132] YouGov found that 70 to 80% of SMEs transact more than half of their business banking online, with 42 to 49% doing all or nearly all of their business banking online.[133]

5.75 Moreover, mobile banking is also seen as important by SMEs. This is reflected in the significant investments which certain of the banks have made to improve their mobile banking platforms, most notably Lloyds, which we understand is investing significantly in developing its mobile banking product.

[132] Datamonitor (2012), slide 27.
[133] YouGov (2013) finds that 70% of micro SMEs (under £100,000 turnover), 75% of small SMEs (£100,000–£999,999 turnover) and 80% of medium SMEs (over £1 million turnover) conduct more than half of their business banking online. 42% of micro SMEs (under £100,000 turnover), 49% of small SMEs (£100,000–£999,999 turnover) and 40% of medium SMEs (over £1 million turnover) conduct more than half of their business banking online. (CMA analysis of YouGov (2013) survey.)

5.76 The growing importance of online and mobile banking is reflected in the strategy and approach from firms which have informed us that they intend to enter the market for the provision of SME banking services using principally electronic or direct means. However, it is noteworthy that these providers are either not established in the sector, or otherwise supply a limited product range, which do not involve cash management services.

5.77 Moreover, and notwithstanding these developments, it remains the case, as we describe above, that many SMEs continue to use branch services to meet their banking needs and continue to consider them to be important and necessary.

Conclusion on distribution of products to SMEs

5.78 We recognise that the usage of local branches by SMEs has diminished in recent years, predominantly as a result of the increased usage of online and, increasingly, mobile banking.

5.79 However, notwithstanding these developments, and consistent with the experience of recent smaller banks, which have sought to expand their SME banking presence, a branch network continues to be particularly important to enable a bank to both acquire and service a wide range of customers. In particular, for providers who seek to achieve a scale retail banking presence to facilitate direct competition with the largest banks, an extensive (and often costly) local branch network appears to be an important prerequisite.

IT systems

5.80 The provision of retail banking products to SMEs requires the setting up and maintaining of complex computer, information and communication systems (collectively referred to as 'IT systems'). These systems are at the heart of a provider's infrastructure and are crucial to the safety and resilience of the organisation.

5.81 The functions that these IT systems need to perform will vary by retail banking product.[134] For example, the provision of a more complex banking product, such as BCAs, will inevitably be more complex than the provision of a simpler banking product, such as a lending engine for a business loan. In this section, we consider first the position as it relates to smaller or new banks, then more

[134] A description of the various functions undertaken by the bank IT systems can be found in OFT (2010), Barriers to entry.

briefly the position with respect to the larger, established banks, after first considering the availability of appropriate technology.

General availability of banking technology

5.82 We are aware of various methods that a provider can use in order to obtain IT systems. These range from:

- developing an IT system in-house
- purchasing an IT system from a third-party supplier
- outsourcing the IT operations to a third party[135]

5.83 While we understand that providers do offer outsourced bank software solutions, this market in the UK is substantially less developed than in the USA, where low-cost, so-called, 'bank in the box' solutions are more common. However, as we show below, it appears that this position may be changing somewhat.

5.84 The cost and complexity of the development of IT systems appears to vary by reference to the types of products which a provider offers. We turn to this issue below.

Providers with a limited product range

5.85 We first considered the position of newer and smaller banks seeking a limited product range, for example specialist lending products.

5.86 We have been told by several of these providers that the costs associated with developing appropriate IT systems are relatively modest. This reflects the relatively limited processing capacity required and the relative simplicity of the products. For example:

- One recent entrant into specialist lending products informed us that the simplicity of its products meant that its IT systems could be relatively simpler
- One alternative finance provider indicated that the development costs associated with its IT systems were £100,000

[135] In addition, and where relevant, a provider, may be able to use existing IT expertise of a parent company.

- One party, which provides IT systems to new entrants, indicated that it would be possible to launch a new savings and loan product at a cost of £2 million[136]

5.87 To the extent that these providers commented upon expansion costs, none indicated that there would be significant costs of expansion. Indeed, one indicated that expansion costs tended to be confined to hardware costs, which tended to be relatively inexpensive.

Providers offering BCAs

5.88 We have also considered the IT position of banks offering a wider range of SME banking products, particularly BCAs, which continue to be important to the overall relationship between the SME and their bank, particularly in the light of the importance of the BCA as a 'gateway product'.

5.89 We have been told that the IT costs associated with developing BCAs are somewhat greater than for simpler products. In particular, there are more significant costs associated with implementing an IT framework which interacts with a wide range of other information systems, particularly those associated with connecting to payment systems (not including the access charges referred to below). For example:

- One bank highlighted that there was a cost associated with offering current accounts of the order of approximately [£5–£10 million] with IT costs being a significant element of that

- Another noted that the bulk of the IT costs were attributable to access to payment systems which allowed the bank to provide a full range of product offerings

- One recent entrant reportedly incurred a cost of between £[✂] million and £[✂] million in [✂]. Such a system would enable it to meet, within reason, demand from all customers [✂].

5.90 However, as noted above, we have also been told about the increasing importance of 'bank in the box' solutions to provide BCAs, with the associated software being provided as an ongoing service, rather than requiring significant upfront investment. We have discussed these solutions, in detail, with a number of providers of these services and understand the core elements to be that:

[136] Meetings with various providers during the market study.

- The software provider provides the bank with a core banking service, which would enable it to provide a range of banking services, including BCAs, and would enable the bank to offer mobile and online banking. The software provider would also provide a range of other services such as relevant security software, albeit in some instances certain services may need to be provided by other organisations.

- The software provider would then be responsible for providing updates to the relevant software.

- The bank would, within certain limitations, be able to differentiate its offer, adding bespoke features at limited additional cost.

- Once established, there would be no significant limitations on the number of customers that could be effectively serviced.

5.91 In contrast to more traditional cost structures for establishing IT systems, only limited upfront investment would be required (largely in initial consultancy costs), with the bank then paying the software supplier a charge based upon the number of accounts which the banks' customers open; we understand that such account charges can be very modest and, as a result of this charging structure, are only incurred as a bank develops its customer base, rather than before it has done so.

5.92 Although we note that 'bank in the box' solutions are relatively untested in the UK, we are aware of several examples of banks which have used, or are seriously considering the use of, such systems, demonstrating their viability.[137] We recognise that various of the providers offering such services in the UK have extensive international experience in the provision of banking software services.[138] We are encouraged by such developments, which we consider to have the scope, potentially, to reduce substantially the IT costs associated with entry into the sector.

5.93 Unlike regulators in some other jurisdictions, the PRA's and FCA's remits do not, under current legislation, extend to the direct oversight or authorisation of technology companies and their solutions, such as 'bank in the box' approaches. Although concerns have not been raised during this market study about regulatory barriers to providing new financial service solutions for potential entrants, the FCA is focusing on whether it could do more to promote

[137] [✄]
[138] This includes, in particular, Temenos and Fiserv, which each have extensive international experience. We note that Fiserv recently launched its Agiliti software solution in the UK. Agiliti is designed to 'reduce the high cost, and mitigate the risk of market entry, for new and existing market participants' and contribute to a 'transformation' of the UK financial services sector.

competition and innovation in financial services. Project Innovate is an FCA initiative which will help both start-ups and established businesses bring innovative ideas to financial services markets. The FCA is engaging actively with, amongst others, financial technology firms to understand better any challenges in the area and has put out a call for input seeking the views of innovators in financial services.[139]

Wider functionality

5.94 However, we have been told that developing a more sophisticated range of products beyond BCAs (such as foreign exchange), which will be of particular relevance to larger SMEs, is likely to be significantly more expensive. Indeed, we have received evidence from [✂] that it has incurred over £[✂] million in IT expenditure to upgrade its corporate banking platform, [✂]; however, we recognise that some of this spend may reflect the need to integrate new IT into existing systems; developing these as stand-alone new products may be less expensive.

IT costs of larger established banks

5.95 We have been told by various providers of SME banking services that the larger, existing banks tend to use in-house-developed IT systems, which are based on batch processing methodologies, whereby a batch of data is collected for processing, often overnight. We have also been told by some of the large banks that these 'legacy' systems were sometimes developed several decades ago, and have involved integrating various pieces of existing technology with other technologies, often from a different bank. This leads to significant cost and complexity, as well as concerns about reliability. Indeed, some of the larger banks have submitted that these systems may mean that newer or smaller banks have a significant competitive advantage, in that they are free to develop simpler, technologically advanced systems.

5.96 This is consistent with research we have seen noting that many established banks rely on legacy core IT systems that rely on applications which have been patched multiple times in an attempt to manage the demands of regulatory changes, rising transaction volumes and digital channel changes.

5.97 We also understand that the expansion costs associated with such systems are also much greater, reflecting the capacity constraints associated with these systems.

[139] FCA Project Innovate Call for Input

Further developments and conclusions

5.98 During the market study, we have not received evidence to suggest that new and potential entrants face significant and unsurmountable difficulties in acquiring IT systems. In particular, the costs associated with developing IT systems for simpler loan products appear limited, something which is consistent with our finding earlier in the chapter, where we highlight the emergence of several providers of specialist lending products in recent years.

5.99 While the relevant cost and complexity appears to increase with the development of IT systems to support a BCA, again these do not seem to be insurmountable, particularly with the increasing emergence of 'bank in the box' IT solutions which are likely to help banks enter, develop and grow. While we recognise that many such systems are at an early stage in development, it seems highly likely that historic barriers to entry and expansion in this area may be starting to diminish.

Access to payment systems

5.100 Payment systems, which allow monetary transfers between account holders, are an essential part of modern banking.

5.101 A payment system is defined by a system of common rules and standards designed to enable persons to make transfers of funds. These common rules and standards are determined collectively by member organisations and govern how a particular system of payments is administered, how payments are processed, and the criteria payment service providers need to meet in order to access and use the payment system.

5.102 The UK has a range of payment systems that deliver many of the payment needs of personal and SME customers:

- BACS (Bankers Automated Clearing Services): An automated net settlement system to make payments directly from one bank account to another, primarily used for direct debits and direct credits. Payments take three working days to clear.[140]

- C&CCC (Cheque and Credit Clearing Company): A system which provides for the clearing of all cheques and other paper-based instruments in the

[140] 'Clearing' is the process by which payments are transmitted, authenticated and reconciled among the payment service providers in a payment system. Settlement for most payment systems is finalised in central bank money at the Bank of England.

UK. The clearing timescale for payments varies according to the type of account into which they are paid.[141]

- CHAPS (Clearing House Automated Payment System): An automated system, which guarantees same-day payments between accounts so long as the instructions are received by 2pm on a working day.

- Faster Payments: An automated net settlement system, similar in concept to BACS; however, it allows near real-time clearing of payments.

- Link: An automated net settlement system which provides the interconnections underpinning the Link network of cash machines in the UK.

- Payment card networks: These are most notably Visa, MasterCard and American Express.

5.103 Participants in payment systems include the operators of the payment system (ie the companies that govern the functioning of the payment systems, such as BACS Payment Schemes Limited), the infrastructure providers (ie the institutions that maintain the network of payments infrastructure required, such as Vocalink, the main infrastructure provider[142]) and the payment service providers (ie the financial institutions that provide payment services). There are widespread networks of overlapping and common ownership structures in UK payment systems. The largest UK banks are not only the largest users of payment services, but also have collective control of the payment system operators and Vocalink.

5.104 For any provider of payment services, direct or indirect access to payment systems is important for ensuring that its customers are able to make and receive a wide range of payments from their accounts, such as direct debits or online banking payments; indeed without this, it is not possible to offer a fully-functional BCA. The ability to provide payment systems is particularly important for many SME customers, given the relatively high dependence on electronic payments and the large volumes of such transactions often used.

[141] The 2-4-6 timescales, introduced in November 2007, set a maximum time limit of two, four and six working days for each stage after paying in a cheque, bankers' draft, bankers' cheque or building society cheque to a UK sterling current or basic bank account. The payee starts to receive interest at the latest from two working days after its bank receives the cheque; is able to withdraw money at the latest from four working days after the bank receives the cheque; and after six working days the payee can be certain that the cheque will not 'bounce', and the money cannot be reclaimed from its account without its consent. For savings accounts, the maximum time limit for withdrawal is six working days, rather than four. See www.chequeandcredit.co.uk.
[142] The Bank of England owns and operates the other major infrastructure provider in the UK – the Real Time Gross Settlement system (RTGS). CHAPS uses RTGS to clear and settle transactions. Other recognised payment systems such as CLS also uses RTGS to clear and settle transactions.

5.105 For a bank wishing to access payment systems, it can do so directly through membership of the payment schemes or indirectly through a sponsor which has direct access. We consider each of those options below.

5.106 A bank that wants to become a direct member has to obtain permission from the scheme owners (ie other direct members, which may be in competition with that bank) and is required to meet a number of criteria, established by other scheme participants, including that the institution:

- is a bank or building society
- holds a settlement account at the Bank of England
- meets the schemes’ technical and operational requirements (including IT systems or an agreement with Vocalink or other provider of the approved clearing services)
- contributes to the costs of maintaining and developing part of the scheme
- takes on any settlement risk that may arise from the default of members of the system[143]

5.107 The fact that many of the payment systems are controlled, in effect, by the larger retail banks raises the possibility that conditions for membership could, in theory, be established in a manner that favours incumbents, at the expense of potential new entrants through making direct access particularly time-consuming, cumbersome or unduly expensive.

5.108 During the OFT’s review of entry barriers in 2010 and the subsequent short review of payment systems in 2013, it found that there were challenges to smaller institutions and new entrants in applying for direct membership of the payment schemes. This was partially on the basis that they did not process sufficient numbers of payments to make direct membership cost effective.[144] Similar concerns have been expressed during this market study by smaller banks that have considered direct membership of payment systems, with one noting that the costs and complexity associated with direct membership can be prohibitive.[145]

5.109 To avoid these challenges, newer entrants and small banks often use agency access arrangements over direct membership. However, to obtain agency

[143] OFT1498 (2013), Payment Systems, paragraph 5.6 (OFT (2013), Payment Systems)
[144] OFT (2010), Barriers to entry, paragraph 6.36, and OFT (2013), Payment Systems, Chapter 5.
[145] Meeting with a smaller and newer bank.

access, providers would be dependent on entering into an agreement with a bank which has direct access.

5.110 During the study, we have heard concerns that smaller providers have experienced little choice regarding agency access. In some instances, small providers have told us, consistent with the OFT's review of payment systems in 2013, that they have been faced with only one or two potential agency providers. One bank told us that, having entered into an agency agreement with a larger bank, it used that bank's sort code for processing payments, with the result that it was difficult to multisource or switch providers of agency access to payment systems.[146] Furthermore, concerns have been raised about the cost incurred by newer or smaller banks in obtaining agency access, particularly for the Faster Payments system. The FCA, for example, identified in 2013, based on anecdotal evidence, that 'industry participants reported that the costs of agency banking are very high for some new entrants'.[147] This is consistent with recently published BBA research which found that 'all of the challengers … highlighted access to payments as a particular concern'.[148]

5.111 In our study, two concerns have been highlighted in relation to the cost of agency access to payment systems:

(a) Some banks submitted that they faced per transaction charges which exceeded a level they considered they could charge to their customers.

(b) Others submitted that there was a significant differential between per-transaction charges at the larger banks, which were members of the payment systems, compared with the smaller providers.

5.112 These concerns about the cost of indirect access were echoed in the BBA research above which found that 'many [smaller and newer banks] argued that they were paying too much'; these banks also argued that they were paying 'a multiple of what it cost the incumbent banks to process payments'.[149]

5.113 In order to assess the extent to which these concerns might act as a barrier to entry, we have reviewed information from each of the major banks, including information on their five most recently agreed agency agreements, with a view to comparing these with the retail prices charged by banks with direct access to SMEs. This information did not enable us to draw any firm conclusion on the issue, although the information was not fully consistent with the concerns expressed above – most particularly there was no evidence that transaction

[146] Various meetings with smaller and newer banks.
[147] FCA, Barriers to Entry (2013).
[148] BBA (2014), p65.
[149] BBA (2014), p65.

costs were set at a level in excess of prevailing retail prices. However, a comprehensive analysis of this issue would require an assessment of the costs incurred by the providers of agency access to payment systems. Such an analysis is beyond the scope of a 'Phase 1' market study.

5.114 In addition to concerns about cost, we were also informed about concerns that agency banks may experience a service level that they consider is below that of the service levels experienced by direct members themselves. One bank which obtains indirect access through agency arrangements, for example, told us that it had experienced over 80 disruptions to service over a 12-month period. Moreover, it has also been suggested by the same bank that it is only able to obtain customer service support during office hours, meaning that any disruption outside that time leads to significant service disruption for its customers, which is not something faced by the customers of direct members.

5.115 Moreover, and notwithstanding the high-level pricing analysis which we have undertaken during this market study, it is important to note that the cost of access payment systems was the barrier to entry most frequently highlighted by potential providers as having the greatest impact on the ability of a bank to provide a wide range of services to SMEs. It may indeed be the case that the widespread perception of the costs and challenges associated with accessing all necessary payment systems represents a significant barrier to entry in itself.

The regulation of payment systems

5.116 In March 2013 the Government published a consultation, 'Opening up UK payments', setting out its proposal to introduce independent economic regulation to payment systems, overseen by a new competition-focused, utility-style regulator. In doing so, the Government highlighted concerns that the structure of the industry gives incumbents an opportunity to restrict the entry of smaller and newer providers. The OFT responded to that consultation.[150]

5.117 Following that consultation, the Banking Reform Act was enacted, requiring the FCA to establish a new payment systems regulator. The new PSR was established on 1 April 2014 as a subsidiary of the FCA, with its own Managing Director and board (now in place).

5.118 The PSR's objectives will be to promote competition, innovation, and the interests of end-users through overseeing designated UK domestic payment

[150] OFT (2013), Payment Systems.

systems. In doing so, it will have a wide range of significant legal powers, including:

- concurrent powers to make MIRs under Part 4 of the Enterprise Act 2002, with effect from 1 April 2014
- concurrent powers to apply the UK and EU prohibitions on anticompetitive agreements and abuse of dominance, with effect from April 2015
- the regulatory power to:
  - — give directions to providers on required actions and standards
  - — impose a requirement regarding payment system rules
  - — require access to payment systems
  - — vary agreements relating to payment systems
  - — require disposal of an interest in a payment system

The PSR will be able to use these powers from April 2015.

5.119 In March 2014, the PSR launched a ‘Call for Inputs’ for stakeholders to provide evidence/information to assist the FCA in setting up the regulator with appropriate resources. Since April 2014, the PSR has held a number of stakeholder events to open up discussion between industry stakeholders on a few of the key areas of concern including access, innovation and infrastructure. The PSR has also commissioned research to further its understanding of the infrastructure and architecture of UK payment systems, governance arrangements, access to payment systems, innovation and what the PSR’s regulatory approach could be. This research will be concluded and published by the PSR over the summer.

5.120 The PSR will use the insights gained from the research, the responses to the ‘Call for Inputs’ and industry engagement to form its policy ideas. The PSR intends to consult on its policy direction in the autumn. We understand, however, that the issue of access to payment systems is likely to be one of the key priority areas for the PSR.

Conclusions on payment systems

5.121 As with previous competition studies, various concerns have been expressed about access to payment systems acting as a barrier to entry or expansion to smaller and newer banks for BCAs.

5.122 However, we note that the PSR, which will become fully operational in relation to the regulation of payment systems in April 2015, is already examining access to payment systems. It is currently devising its regulatory approach, such that it is not possible to say at this point how it may address these concerns. However, we note the PSR's wide-ranging powers to address concerns in relation to payment systems. In particular, we note the focus of the PSR on access issues in the 'Call for Inputs'.

Access to key information[151]

Informational asymmetries between banks – customer creditworthiness

5.123 Accurate information about a business's past financial performance ('creditworthiness information') is crucial to enabling providers to make effective lending decisions when offering the provision of credit, such as overdrafts and loans, to SME customers. A consequence of limited access to such information could be that providers cease to offer lending products for consumers for whom they cannot accurately calculate risk, or that they lack sufficient information to offer sufficiently attractive prices such that they can effectively compete. This concern is consistent with academic research that in the presence of information asymmetries, concerns arise regarding adverse selection on the part of lenders,[152] moral hazard on the part of borrowers[153] and a market equilibrium characterised by higher prices, less lending and higher defaults than would be the case in a perfectly competitive market.[154]

5.124 Various studies have suggested that such concerns may be present in the SME banking market, with particular concerns expressed that limited access to credit information on the part of smaller and newer providers may constitute a barrier to entry or expansion in SME lending, including in the CC inquiry and the Breedon review in 2012.[155]

Findings on access to information on creditworthiness

5.125 The information required to assess an SME's creditworthiness differs by the size of the loan and the product. While certain information about SMEs might be available through third parties (such as credit reference agencies (CRAs)),

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[151] In addition to creditworthiness information, which is the subject of this section, newer and smaller banks may also benefit from information to help them to more effectively target SMEs. In this regard, the CMA notes the publication, by the BBA, of postcode-level lending data to enable newer and smaller banks to move into areas that were not currently well served by banks.
[152] For example, where banks are unable to differentiate sufficiently between borrowers with different levels of risk.
[153] For example, whereby borrowers may change their risk-taking behaviour once they have received a loan.
[154] See 'Should the availability of UK credit data be improved?', Appendix 1.
[155] CC (2002), from paragraph 2.205; Breedon Review (2013), p37.

we have also been told that, in many instances, the most valuable information which providers need to offer loan products is transactional information of the type which is included in the SME's BCA.

5.126 However, this information is principally held only by the bank that provides the customer's BCA. To the extent that such information is shared, which is to a very limited degree, it is shared with CRAs through 'closed user groups'. Membership of such groups is limited on the basis of the so-called principle of reciprocity whereby 'subscribers receive the same credit performance level data that they contribute, and should contribute all such data available'. Although, in principle, this could enable new entrants or alternative finance providers to access the limited BCA data available, we understand that, in practice, they do not.[156]

5.127 Moreover, while such BCA transactional information is available through customers' bank statements, which a customer could provide in paper form to an alternative provider, we understand that direct electronic access to this information is important, both to avoid concerns about potential fraud and to enable the information to be processed in a cost-effective manner. Consequently, an SME's main banking provider has ready access to significantly more information about that SME than any provider which does not offer that service to it.

5.128 During the market study, we have received evidence from various parties on this issue. Several, though not all, of the larger banks have submitted that new entrants or those looking to expand are not significantly disadvantaged for the following reasons:[157]

- First, the information available to an established bank or entrant on a new start-up is the same
- Second, SMEs are increasingly developing their banking relationships with multiple banks, allowing alternative finance access to relevant information to help inform lending decisions
- Third, account activity is only one of a number of information sources used when assessing creditworthiness. There are alternative sources of information readily available or experienced staff which may be recruited to assist in the assessment of SMEs.

[156] Although they may be able to view certain 'warning flag' data which could suggests the customer is over-indebted and whether the customer may struggle to repay credit.
[157] The below arguments are taken from submissions provided by the major banks during the market study.

5.129 However, we have also been told by some, although not all, of the smaller banks that alternatives to BCA information have limitations, particularly with respect to the usefulness of the data. These include, for example:

- the credit-scoring models available to incumbents better predict default than those of CRAs (because in developing their models, banks have had access to more complete and current data)

- that CRAs cannot provide ratings for start-ups, whereas that information will be available to the larger banks from a reasonably early stage (particularly in those instances where the SME's owner had a PCA with that bank)

- CRAs cannot provide data for many sole traders, as generally banks can get reliable data from CRAs on only around 50% of sole traders

5.130 Moreover, from the large banks' responses to this market study, we have also noted the importance that the largest banks themselves place on BCA information when undertaking an assessment of their willingness to lend and on what terms. While this does not demonstrate that this is the sole relevant source of information, it does demonstrate this it is an important source of information and one which may provide incumbents with a significant advantage over competitors.

5.131 We also note that access to BCA information also permits lenders to reduce their risk by monitoring the ongoing creditworthiness of the SME over the loan period, something which is only available to the SME's main BCA provider, again providing it with an advantage.

5.132 For the reasons set out above, we consider that the information asymmetry identified above is likely to create barriers to the entry and expansion of smaller and newer providers.

Action already taken by government

5.133 The Government introduced legislation to Parliament on 25 June 2014 to increase the ability of smaller banks, new entrants and alternative finance providers to obtain access to creditworthiness data on SMEs (including potential BCA information) in order to stimulate competition in the SME lending market. This is intended to be achieved through requiring banks (which meet a certain market share threshold) to share data on their SME customers with other lenders through CRAs, and require those CRAs to ensure equal access to that data for all lenders; the FCA will be responsible for enforcing these requirements. Moreover, the Government also proposes to provide a power for HM Revenue and Customs (HMRC) to make more generally available non-financial VAT registration data to improve credit scoring for smaller SMEs, subject to controls to prevent its misuse.[158]

5.134 We welcome these proposals. We have engaged with HM Treasury and HMRC to discuss these initiatives and have provided HM Treasury with comments to assist with the design of the initiative regarding increased access to creditworthiness data. We consider that, once implemented, these proposals are likely to go a significant way to addressing the concerns above.

5.135 Finally, we note that the Bank of England published a discussion paper in May 2014 on improving access to credit data in the UK by broadening access to UK credit-reporting systems and enhancing available data. To achieve this, the Bank of England outlines a number of potential delivery options, including the involvement of CRAs or the establishment of a central credit register.[159]

5.136 We note, as does the Bank of England, that there will be certain risks and costs associated with making such data available. However, the CMA considers there to be benefits from such a proposal, particularly in:

- facilitating greater competition for small SMEs, by making it easier to identify and match credit data on these businesses
- making data more widely available might support wider use of credit-scoring models and the IRB approach to risk weighting, possibly addressing the concerns set out above in relation to capital requirements

Conclusions on access to key creditworthiness information

5.137 As with previous studies, various concerns have been expressed about access to credit information acting as a barrier to entry or expansion to smaller and newer banks, particularly those seeking to provide lending products. However, we consider that action currently being taken by the Government provides an effective mechanism substantially to address any of the concerns in these areas if implemented in full. We continue to stand ready to provide appropriate assistance to the Government as it continues to take forward these proposals.

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[158] See www.gov.uk/government/uploads/system/uploads/attachment_data/file/322519/bis-14-920-access-to-finance-fact-sheets.pdf. The Government’s proposals are included in the Small Business, Enterprise and Employment Bill.
[159] www.bankofengland.co.uk/publications/Documents/news/2014/dp300514.pdf.

Obtaining financing

5.138 Banks require funding to provide SME banking services. If they are hindered from accessing finance, they may not be able to gain market share or expand operations in response to increased consumer demand or financial innovation. This, in turn, may reduce their ability to exercise an effective competitive constraint.

5.139 Expansion and ongoing lending can be financed through a number of different sources, such as: retail deposits (which come from customers' savings), interbank loans, the issuance of equity (which can involve direct or public selling of new shares to investors), retained earnings, debt securities and through government schemes. However, not all these sources of funding are available to all types of retail banking providers and demand for each type of funding differs by bank. The relative attractiveness of different sources of funds also varies over time, depending on changes in investor confidence and credit ratings, on the costs of running a retail deposit business, on changes to consumers' propensity to save and also on regulatory requirements.[160]

5.140 Banks with a primarily retail model raise funds through customer deposits. Where most of the assets are current accounts and savings accounts, revenue will be based on the net interest margin, that is, the difference between the interest rate that they pay out on deposits and the interest rate that they charge on loans.[161] Compared with other forms of financing, we have heard that deposits are often a 'cheaper' source of funds.

5.141 However, obtaining retail deposits may not be sufficient for the provider's needs.[162] Moreover, established banks are likely to be better able to access wholesale markets, often doing so at a better rate than smaller providers. This allows larger banks to obtain larger amounts of capital at a cheaper rate, relative to smaller banks.[163] We have heard from various providers that the funding advantage enjoyed by the established banks means that they are unable to compete effectively with the largest banks across a wide range of products. Instead they are more likely to focus their activities on those specialist lending products, where the largest banks have chosen not to focus, particularly following the financial crisis where large banks' risk appetites have somewhat reduced, and where larger margins are more likely to be able to be realised.

[160] OFT (2010) Barriers to entry, paragraphs 6.56 & 6.57. In various meetings with smaller and newer banks during the study, we have been told that the financing options which are available to banks differ.
[161] See Financial Stability Report, December 2011, Bank of England, p36.
[162] Meeting with a smaller and newer bank.
[163] Meeting with a smaller and newer bank.

5.142 Access to capital can also be obtained from government lending schemes, such as Funding for Lending (FLS). In meetings with smaller banks, it has been suggested that access to the FLS is dependent on the assets the bank holds and is easier for larger banks to access, when compared with smaller banks, as large banks' asset portfolios are easier to assess and value, and look less risky from a Bank of England perspective.[164] Indeed, some smaller banks have indicated that these schemes could be putting the bigger banks at an advantage by supplying them with a cheap source of funding.[165] We are also aware of concerns that the FLS was designed for the largest banks: any money drawn down from the FLS comes in the form of Treasury bills, requiring smaller and newer banks to put in place a costly repo line to access the funds.[166]

5.143 The information available during this market study has not enabled us to take a firm view on this specific issue. However, we note that these schemes are open to smaller providers, including smaller banks which have significant borrowing allowances under the scheme and have made significant loans to SMEs using that source of finance.[167] Indeed, the Bank of England has recently indicated that 'a number of participants, including some smaller, challenger banks, have successfully used the FLS to expand their SME lending'.[168] These schemes are, in any event, short term in nature and reflect the particular circumstances of the financial crisis.

5.144 Other government-backed schemes also provide financial support to providers of finance to SMEs, including the British Business Bank which, through its investment programme, is providing significant support to innovative providers of finance to SMEs.[169] This may go some way to addressing some of the financing challenges of smaller and newer providers.

Conclusions on obtaining finance

5.145 We therefore note that obtaining finance is a key challenge for newer and smaller providers. However, we also note that this, at least to some extent, is to be expected given that any prospective entrant will have to obtain sufficient finance to effectively operate. However, we note that should newer or smaller

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[164] These concerns are consistent with those expressed in BBA (2014), p69.
[165] Meeting with a smaller and newer bank.
[166] BBA (2014), p69.
[167] For example, the borrowing allowances for lending to SMEs under the FLS for 1 April 2013–31 December 2013 were £345 million for Aldermore, £20 million for Cumberland and £136 million for Shawbrook. See source information.
[168] www.bankofengland.co.uk/publications/Pages/news/2014/040.aspx.
[169] See British Business Bank Strategic Plan, June 2014, p36.

banks be able to develop a sufficiently large customer (and therefore deposit) base this issue would reduce in salience. It is to this subject that we now turn.

Ability to acquire sufficient, profitable customers

5.146 The entry of a full-service bank, or the expansion of a newer or niche bank into a full-service bank, may also face barriers when attempting to attract sufficient volumes of profitable customers to operate at scale. This can be a particular challenge given that the relatively low transactional revenues obtained from many smaller SMEs means that they are only likely to be profitable if a newer or smaller bank is able to acquire significant volumes of those customers.

5.147 Economies of scale occur when the average costs of producing a given product or service fall as the level of output rises. They may prevent entry or expansion across the markets if there is a minimum efficient level of scale necessary to avoid being at a cost disadvantage compared with incumbents. The larger the costs of being a full-service bank, for example through the need to provide an extensive local branch network, the larger the scale entrants need to reach in order to find their operations profitable. We consider customer dynamics in detail in Chapter 8, so we do not attempt a full summary of this issue here. However, by way of summary, we find that there are a number of features of consumer behaviour which make it difficult for a smaller and newer bank to grow to a sufficient scale to effectively challenge incumbent banks. These are:

- low rates of switching
- a strong tendency on the part of SMEs to use their PCA provider as the supplier of their BCA, and subsequently to acquire business loans from that same provider
- a preference for many SMEs to use a single bank which is likely to meet all of their relevant banking needs
- limited SME awareness of alternative provider brands[170]

5.148 These factors in combination are likely to provide a significant barrier to a bank establishing a significant presence in SME banking within a short period

[170] We have not seen significant evidence during the market study that a well-developed brand and reputation is necessary to attract sufficient numbers of SME customers to enable a bank profitably to provide banking services to SMEs. What seems to be more relevant is that SMEs appear to be aware of only a very limited number of SME banking brands, something which we discuss in later chapters and which we also discuss in our focus group research. The difficulties for a newer and smaller bank of obtaining awareness is therefore likely to constitute a significant barrier to expansion, by making acquisition of customers particularly difficult and costly.

of time. This is consistent with various of our discussions with newer and smaller full-service banks, several of which have highlighted that customer acquisition can be costly and difficult as a result of the inability to effectively acquire customers. One has highlighted that a key expansion challenge is persuading customers to ‘look up’ and consider alternatives to their current provider.

Conduct of incumbent banks

5.149 Incumbent banks may raise barriers to expansion through practices which make it harder for existing competitors to compete, thereby inhibiting their growth and development.

5.150 During the market study, we have particularly considered various such practices.

- delays by incumbent banks in granting waivers of security or deeds of priority
- the requirement for providers to take out a BCA with a provider, if they wish to take out a lending product (so-called ‘bundling’)
- selectively offering better prices to new SMEs or those who switch (price discrimination)
- restriction on the provision of banking services to alternative providers

We consider each of these in turn below.

Waivers and deeds of priority

5.151 It is common practice for banks to seek security from many (typically larger) SMEs in the form of a debenture when lending to SMEs to help meet their working capital needs. Under such a debenture, a bank is typically granted both fixed and floating charges over all of a company’s assets.

5.152 When an SME seeks additional finance from an alternative provider, that alternative provider will often look to take security over certain specified assets of the SME. If the SME’s existing bank holds a debenture, the alternative provider will approach that bank to obtain either a waiver of security (under a letter of waiver) or a deed of priority:

- A letter of waiver is most commonly used when a bank holds a debenture and the customer subsequently applies for invoice finance or factoring facilities. The alternative finance provider will seek a waiver (or release) of the bank's security over the receivables (book debts) that are assigned under the invoice finance or factoring agreement.

- A deed of priority is commonly used when the alternative provider wishes to take a second charge over certain specified assets of the SME. It does not involve a release of all or part of the existing bank's security but is a means for the existing bank and the alternative provider to agree the order of priority in which their respective security will rank and their rights in relation to the SME's debts.

5.153 Consistent with certain concerns expressed in the CC inquiry,[171] during the market study we have heard from alternative non-bank providers of finance that larger banks may be unduly delaying or refusing to grant waivers or deeds of priority – a process that can take from between two weeks and 18 months.[172] Secondly, there is the perception that the large banks then use the opportunity to cross-sell their own services, while negotiating the waiver or deeds of priority from existing security. This may mean that the way in which incumbent banks deal with security held by an SME's existing bank can act as a barrier to that SME obtaining finance from an alternative provider and a barrier to the alternative finance provider obtaining customers.

5.154 We have obtained evidence from each of the four largest UK banks on this issue during the market study. Several of the banks indicated that waivers were relatively infrequent and were, in most cases, processed within a matter of weeks, albeit in more complex cases it may take longer. One also said that such requests were rarely refused. However, those banks also indicated that they did not collect data to enable them to provide a specific timescale for how long requests for waivers or deeds of priority took to process in practice, making it impossible to verify the timescales for the processing of such requests.

5.155 While we recognise that certain arrangements can be complex, and dependent on the actions of the SME and not just the bank, we consider that the processes for handling waivers at the major banks could be improved to provide reassurance that such requests would be promptly and efficiently handled, and would not be used in a manner to frustrate an SME from seeking an alternative source of finance. Following constructive discussions with the BBA and several of the banks about this issue in the early part of 2014, the OFT called upon the industry to take swift and effective action on this issue,

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[171] CC (2002), paragraphs 8.155, 8.169 & 8.526.
[172] Meetings with various newer and smaller banks, and alternative finance providers.

particularly to improve the processes by which requests for waivers over security or deeds of priority are granted.

5.156 Subsequent to the OFT's call for action and concerns about this issue being raised by HM Treasury, the BBA announced on 19 March 2014 that a protocol had been agreed with Barclays, RBS, Lloyds and HSBC to enable alternative lenders to agree more readily with banks standard forms of Deeds of Priority or Waivers to small businesses seeking other finance options through:

- listing their standard documents on their website, such that standard requests can be dealt with more promptly on the basis of existing templates
- having a central coordination point to respond to requests from alternative lenders to create new arrangements
- agreeing to notify businesses of their decisions within seven working days for all but the most complex cases (provided all of the relevant information needed to make an assessment is provided by the SME concerned)
- in the case of declined requests, clearly stating the reasons why the bank is not able to comply with the request to the customer and allow the customer to follow the usual appeals procedures if they are not satisfied[173]

5.157 We very much welcome this initiative from both the BBA and the largest UK banks which we expect will be fully implemented by October this year. We then expect each of the banks to act in a manner consistent with that protocol. In the event of future concerns, both about this issue and other activities which could frustrate the development of the alternative finance sector, the CMA reserves the right to take further action to support the continued development of a potentially innovative source of finance for SMEs.[174]

Bundling

5.158 Alongside the market study, the CMA is assessing undertakings given by various banks following the CC inquiry. As part of that ongoing review, the CMA has received concerns about failures to comply with those elements of the undertakings which prevent banks from requiring an SME to take out a BCA in order to obtain a business loan[175] (that is 'bundling' of BCAs with

[173] See BBA press release.
[174] In considering whether to take any further action in relation to any particular issue, the CMA will have regard to its published prioritisation principles.
[175] Or a business deposit account. The CMA's focus during this review has been on potential bundling of BCAs with business loans, as that is where concerns have been expressed to us.

business loans). The CMA considers that compliance with these undertakings is important as they are designed to help providers to compete effectively in SME banking, particularly by helping an SME to take out a loan product from a provider with which they do not have a BCA.

5.159 Further information about the CMA's assessment of these concerns is included in Chapter 11.

Price discrimination

5.160 As noted in Chapter 3, banks often offer a period of 'free' banking for switchers and even longer periods of 'free' banking for start-ups, with the result that certain customer groups effectively cross-subsidise others.

5.161 We have observed that banks can price-discriminate between new-to-bank and existing ('back-book') customers. The CC identified this structure of pricing as likely to provide a cost advantage to incumbents relative to new entrants, as new entrants are required to offer free banking in order to compete, increasing entry costs and thereby creating a barrier to entry.[176]

5.162 While we acknowledge that start-ups benefit from such an approach and that there are benefits to providing such offers to SMEs as they are being established, the free banking offer increases entry barriers, increasing the costs that a new entrant will need to incur to enter the BCA market, increasing the timescales for those entrants to make a return on new entry.

Restriction on the provision of banking services to alternative providers

5.163 We have also heard concerns from some prospective providers of SME banking services, including peer-to-peer providers, that certain large banks may be reluctant to provide them with banking services. This can be manifested through banks requiring new providers to complete detailed, time-consuming forms to access banking services. However, we also recognise that the banks must satisfy themselves that those they provide banking services to must have adequate procedures in place to comply with anti-money-laundering obligations. Moreover, we have not received evidence that the banks are strategically acting in a manner to prevent the emergence of alternative finance providers by denying banking services to them.

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[176] CC (2002), paragraph 2.209.

Conclusion on barriers to entry and expansion

5.164 The evidence we have seen during the market study has indicated that barriers to entry and expansion differ considerably in size and intensity, depending on the particular SME banking product offered by a provider and that provider's choice of business model.

5.165 Entry into specialised lending products or similar product niches appears to be relatively straightforward, requiring limited upfront expenditure, and facing few barriers in obtaining the key inputs required, both for entry and expansion.

5.166 For full-service providers, providing multiple products, there are positive indications that several historic barriers to entry or expansion may be diminishing as a result of technological and regulatory change. However, it remains the case that only one new full-service provider has entered the SME banking market in recent years. We see no evidence that the newer providers in the sector represent a real scale threat to the largest banks.

5.167 We consider that in addition to the likely limited profitability of serving smaller customers, this reflects continuing and significant barriers to a bank expanding its market share. The most significant of these barriers continues to be the features of SME behaviour that make it difficult to acquire customers and the continued importance of branch networks. We have also heard concerns about the challenges of accessing payment systems and about the impact of capital requirements, both of which may result in smaller and newer providers being less able to compete effectively with the large providers, restricting their ability to expand.

6. Introduction to demand side issues: SMEs' attitudes and behaviour

Introduction

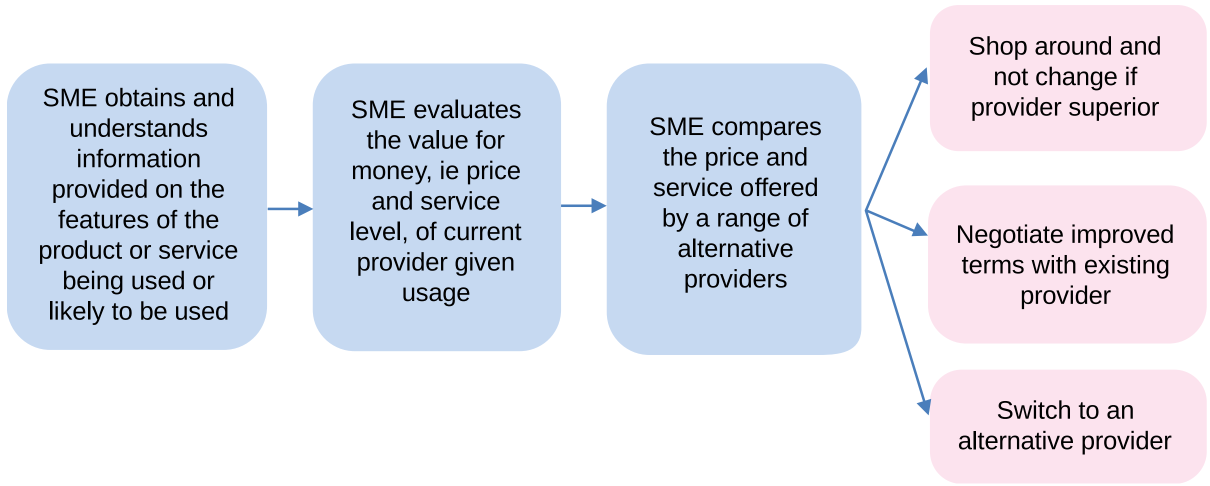
6.1 This chapter provides an introduction to the demand side of the SME banking sector. It explores the way in which SMEs, as customers of financial products and service providers, could drive competition and the steps needed for this to take place.

How customers could drive competition among providers

6.2 The process by which engaged SMEs could drive competition involves a number of steps, as illustrated in Figure 6.1 below.

FIGURE 6.1

How SME engagement can stimulate competition among providers



Source: CMA.

6.3 The dynamic created by greater SME engagement would drive the competitive process by ensuring that competitive providers benefit from increased custom, while less efficient and less competitive providers lose it. However, for this process to work effectively, and therefore for competition in SME banking markets to work well, SMEs need to:

- have sufficient information to understand the financial products and services they use and need
- understand the full costs and service levels of the products they use
- be able to compare effectively the different price and service offers from rival providers and assess which is best for them

- act on this information, either by switching, negotiating better terms or realising they already have the most competitive and suitable product or service provider[177]

They therefore need to be able to access, assess and act on information to ensure that they obtain the best possible deal.

6.4 We consider whether they are able to do so in the following chapters.

[177] This process is an application of the framework set out in the OFT's 2010 paper: 'What does Behavioural Economics mean for Competition Policy? March 2010, OFT1224. This set out a three-stage process by which customers could drive competition including accessing information, assessing offers and acting on the information.

7. Transparency and comparability

Key facts and findings:

- The pricing of BCAs and loans appear complex. For both BCAs and loans, it can be difficult for SMEs to get a detailed understanding of the cost of using these products.
- SMEs find it difficult to compare prices between providers and even more difficult to distinguish differences in service quality. Overall, challenges remain for SMEs who wish to evaluate their current provider against potential alternatives in the market.

Introduction

7.1 As we set out in Chapter 6, for there to be a competitive SME banking market, it is important that SMEs are sufficiently aware of their banking needs and are able to select the right financial products and services to meet those needs. Moreover, in choosing a supplier, SMEs need to be able to understand the features of the product or service they require to see how much they would pay for this given the pattern of usage they expect; and to compare the offerings from different providers in the market to select the one that gives them the best combination of price and service quality to suit their requirements.

7.2 This chapter examines the ability of SMEs to select appropriate financial products and their awareness of them. It also examines the extent to which the focal products are transparent to customers, allowing them to select appropriate products and services for their business, and to make effective comparisons across providers.

7.3 We first consider the findings of previous studies which have considered this issue.

Findings of previous studies

7.4 There have been long-standing concerns about the transparency of banking services for SMEs, starting with the Cruickshank report in 1999. This was later elaborated on in the CC’s inquiry, which ultimately led to the largest banks at that time being required to compile and make available information showing their tariff charges payable by SMEs for money transmission services, among other transparency requirements.

7.5 Similar concerns about transparency were expressed by the ICB in 2011, which found that comparison was often difficult since price comparison sites did not appear to be effective in comparing current accounts, with little incentive for websites to invest in improving this. It also noted that a low proportion of BCA account openings were made through comparison websites.[178]

Selecting financial products and services

7.6 Financial products and services are often complex and difficult to understand, given the variation in pricing structures and features among providers. However, in order for SMEs to consider and select from available financial products, SMEs would need to have at least a basic understanding of their financial options, and the knowledge and awareness to make effective financial choices.

7.7 However, we have been informed by various parties during the market study that many SMEs, principally smaller SMEs, have a relatively limited degree of financial knowledge, with one source noting that many were not investment or bank ready. We have also been told that many SMEs lack knowledge of bank requirements for providing finance to SMEs or sufficient business planning experience. Furthermore, research by Quadrangle concluded that SMEs were not held back by a lack of choice, but rather a lack of knowledge and confidence.[179] This lack of knowledge is likely to arise partially from the limited time which owners or employees of SMEs, particularly smaller SMEs, may devote to managing their banking needs, given the range of other business-related activities they will be engaged in, which are likely to be of greater salience to them than their banking provision.[180]

7.8 This lack of knowledge and awareness is reflected in the very low level of awareness by SMEs of banking providers, other than the largest banks, as demonstrated in various research:

- In our focus group research, the SMEs included were aware only of the largest providers.[181]

- FSB research shows that fewer than one-fifth of SMEs were aware of Handelsbanken when prompted, one of the best established of the smaller and newer banks.[182] Unprompted awareness of smaller and newer banks

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[178] The Vickers Review
[179] Quadrangle, (2013) a, slide 44.
[180] BDRC focus group research, slide 73.
[181] BDRC focus group research, slide 8.
[182] ‘FSB Voice of Small Business Survey Panel’ report, August 2013, slide 30.

is much lower; in survey research asking about awareness of banking providers, the most frequently referred to newer or smaller bank was only mentioned by 6% of respondents; Handelsbanken was only mentioned by around 1% of respondents as a bank they were aware of.[183]

7.9 Moreover, we understand that SME awareness of alternatives to bank finance is often very limited. Research carried out for the Business Bank[184] showed that fewer than one-third of SMEs were aware of invoice finance or factoring. A similar proportion were aware of business angels, export/import finance or peer-to-peer lending, and around 5% were aware of crowd sourcing or mezzanine finance. The CBI has concluded that awareness of alternative sources of finance was lower in small and growing businesses, with only 20% of SMEs being aware of a local venture capitalist, while many were not aware of government schemes designed to help them. It concluded that low awareness of alternatives arises from a mutually reinforcing cycle of low visibility and low usage of these products.[185]

7.10 This general lack of financial knowledge and awareness of alternatives to the largest banks among many SMEs, is an important aspect of considering whether SMEs are sufficiently engaged to drive competition between providers.

7.11 Given this limited awareness of alternatives, we particularly welcome the Government's consultation on potential legislation to help match SMEs that have been rejected for loans with smaller, newer and alternative providers. This includes the Government's preferred approach of requiring banks to refer details of SMEs that have been rejected for loans to a platform or platforms so that they can be accessed by smaller, newer and alternative providers. This could increase SME access to and awareness of alternatives to the largest banks over time.

Transparency and comparability in the competitive process

7.12 Transparency about levels of service and price, combined with the ability of SME customers to compare and act on offerings between different providers, are central aspects of the competitive process.

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[183] Charterhouse, Response to questions B1a and B1b.
[184] BMG (2013), p72.
[185] CBI submission to the taskforce for alternative and sustainable finance sources, 2012.

Pricing transparency and comparability

BCAs

Customers on standard offers

7.13 Smaller established SMEs tend to receive standardised tariff offers, where their prices are those included in a standard generally applicable SME tariff.

7.14 We have been informed by the banks that BCA tariff information is readily available. They have highlighted that such information is generally available on websites, product literature and from branch staff, as well as in some cases on tariff calculators available on bank websites.

7.15 However, we note that BCA pricing structures are generally complex. Most banks impose charges for a number of individual transactions.[186] Some banks offer accounts where a monthly charge is levied for a set number of transactions. In order for an SME to understand and compare all of these charges, we would expect them to need a detailed understanding of their transactional behaviour and the transactional charges applied to their BCA. However, the complexity and variety of charges mean that customers generally are unlikely to be aware of both their own charges and also the charges they would pay if they used an alternative provider. This makes it difficult for an SME to make an accurate assessment of the benefits of switching.

7.16 That such a comparison is complex is consistent with evidence we have received during this market study. According to Mintel, a significant minority of SME customers, that is 33% of surveyed SMEs, agreed that 'it was difficult to compare all of the costs charged on business bank accounts'.[187] Further, one bank provided survey evidence[188] indicating that 15% of SMEs that had switched in the last five years found it difficult to access pricing information from banks and assess which of those banks offered the best pricing option depending on the SME's account usage (with a further 30% finding it neither easy or difficult). Our focus group research also confirmed that many SMEs admitted to finding it difficult to identify differences and make comparisons across providers.[189] This is supported more generally by Quadrangle research

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[186] Possible BCA fees include: account maintenance fee; automated credits; bill payments; branch cash-in; branch cash-out; branch cash collected; branch counter collection; branch credits; business Internet banking BACS payment; cash machine withdrawal; cheques paid; debit card payments; direct debit charges; internal transfer charges; Internet bill payments; and standing orders.
[187] Mintel (2013), Figure 57.
[188] Survey information provided by a major UK bank, p31.
[189] BDRC focus group research, slide 62.

that showed that between 44 and 60% of SMEs think choice is available in the market, but that selecting the right bank for their business is difficult.[190]

Start-up SMEs and SMEs in receipt of bespoke offers

7.17 For start-ups, they will generally receive a period of so-called ‘free’ banking. While this, in some respects, means that the pricing is transparent, it is likely also to mean that many SMEs do not focus on the longer-term costs of operating a BCA when opening a BCA. Moreover, they are, at that point, likely to be unaware of future transactional behaviour which will form the basis of the prices that will be charged when their introductory offer expires.

7.18 Most large banks provide information to SMEs on BCA pricing structures either a few weeks or months before the end of their free banking period. This varies from simple information showing the tariff the SME will move onto; to communication over options for different tariffs; to a discussion with a relationship manager about the most suitable product and tariff. Therefore, it is only a few months or weeks before the end of the free banking period that many SMEs will be clear about their future BCA costs.

7.19 This means that start-ups may not be particularly focused on tariffs at the start of their banking relationship, limiting the extent to which providers have incentives to compete intensely on price, at this stage in the relationship.

7.20 For those customers on bespoke offers, where the prices paid deviate from published tariffs, the position is more complex (bespoke pricing is discussed in more detail in Chapter 8). In those instances, a larger SME, which may expect to benefit more from such bespoke prices, will have to negotiate actively with an alternative provider to establish a particular bespoke price for them. This will, by its nature, increase the time and complexity associated with comparing an existing offer to prospective offers available from other providers.

Tools to aid transparency and assist comparability on BCAs

7.21 We are aware that various providers have put in place tariff calculator tools to assist an SME in establishing the tariff offered by that provider which would be best for them based on their transactional behaviour. However, while such tools are obviously helpful, they do not typically allow for easy comparison across different providers to assess the cost of different BCAs across the

[190] Quadrangle (2013)a, slide 23. The difference between the two figures is based on differences in age and legal status of SME, and regardless of the size of the SME.

market, requiring customers to undertake a manual comparison between different providers.[191]

7.22 We are aware of certain comparison tools that are intended to assist SMEs to make comparisons between different providers. However, as one large bank has acknowledged:

> customers arguably still lack the tools to compare the BCA offerings from different finance providers quickly and easily: SME customers can currently compare tariffs effectively only by expending considerable time and effort manually researching different providers' tariffs.

7.23 Moreover, we also understand that current comparison tools have seen very limited usage from SME customers. The Business Account Finder, we have been told, receives only 30,000 page views per year, in an environment where there are over 4 million SMEs. In any event, the Business Account Finder does not provide a comparison based on an SME's expected transactional behaviour, but instead displays a list of available tariffs. This means that the customer must be both aware of their expected transactional behaviour and undertake a manual calculation of different tariffs based on their usage in order to determine which provider offers them the best deal. Other online comparison tools that we were made aware of are similarly likely to be of limited use in making effective and accurate comparisons of pricing and charges.[192] As we describe later in this section, however, there have been more positive developments in relation to a website to facilitate service comparisons, the Business Banking Insight.

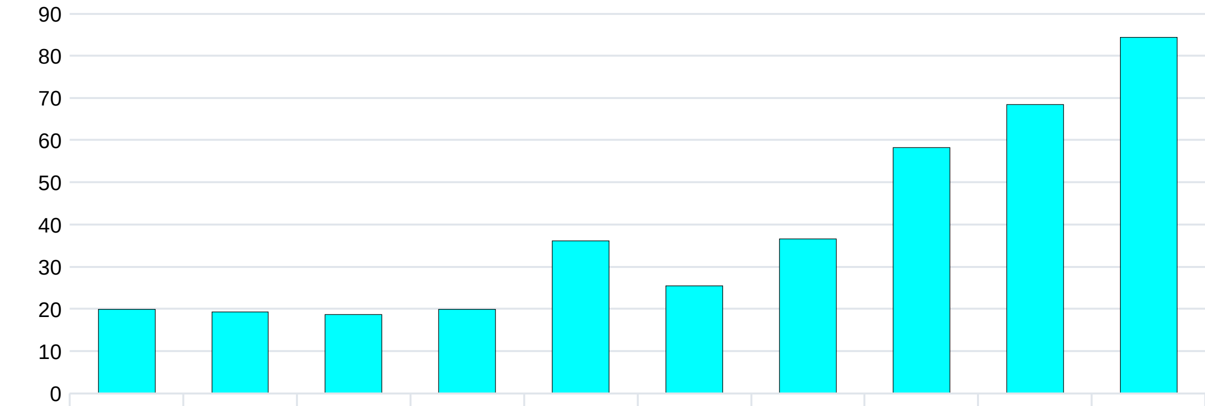
7.24 More generally, tools for comparing the costs of different tariff structures will have limited effect on competition in the market, where the use of such tools requires substantial effort on the part of SMEs. In addition, where SMEs are not engaged by their retail banking products, services or providers, they are unlikely to be willing to invest time in considering these products and services, and therefore less likely to examine the tariff structure, let alone compare providers or consider switching. Therefore, while improvements to tools of this type may impact on those SMEs engaged with their banking products and services, it may not have a significant wider impact on less well-engaged SMEs.

[191] One exception is Santander which alerted us to BCA comparison tools on its website, which compares it with five other providers based on user input of their transactions. This gives a simple breakdown of the amount that can be saved by choosing that provider, but does not break down how such savings arise.
[192] For example, Business Money Facts compares just ten banks on only three criteria – credit interest, the notice period and the minimum deposit to earn this interest rate. We note that the Government's midata initiatives in relation to price comparison do not currently include BCAs (or other SME banking products).

7.25 Consistent with our assessment that SMEs have difficulty with comparing the costs of BCAs from different providers, we have identified some significant differences in actual costs depending on SMEs' usage. This is shown in Figure 7.1 below, which presents monthly differentials between providers by reference to ten BCA usage scenarios, which have been provided by one bank (these scenarios are considered in more detail in Chapter 9).[193] Notwithstanding these differences, however, as we describe in Chapter 8 we see only very limited switching between providers.

FIGURE 7.1

The dispersion of monthly BCA charges in Great Britain



	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6	Scenario 7	Scenario 8	Scenario 9	Scenario 10
GB	20.00	19.35	18.70	20.00	36.10	25.55	36.55	58.20	68.40	84.40

Source: CMA/FCA analysis.

Interest forgone

7.26 Another significant cost to SMEs is the value of interest forgone on credit balances held in their BCA. Interest forgone can take various forms, but essentially, it is the difference between what an SME earns in credit interest from its current account and what it could earn from the money elsewhere. In order to determine what an SME could earn from the money elsewhere, one can look to either the interest on another product such as an instant access savings account, or to the Bank of England base rate.

7.27 We recognise that, since the financial crisis and recession, the Bank of England base rate of interest has been low. However, that notwithstanding, each of the four largest UK banks has continued to earn a significant proportion of their revenues from BCA customers' credit balances, upon which

[193] The Barclay's ePayment and RBS Business Banking Direct tariffs may be seen as 'outliers' which influence the dispersion of prices and have been removed from this analysis.

the banks typically pay little or no credit interest.[194] Therefore, on at least one measure, interest forgone is a significant cost for many BCAs.

7.28 It is complex for an SME to calculate the value of interest forgone, particularly for those that hold differing amounts of money in a BCA over a week, month or year. This is because it will require detailed knowledge of account usage as well as knowledge of the existing interest rate of their provider.

7.29 However, we have seen no evidence that relevant information is available to allow SMEs to calculate this element of the cost of their BCAs by any measure considered above or other similar measures. However, we also have no evidence that credit interest rates are a significant factor in SMEs' decision-making processes, particularly during a period of very low interest rates.

Business loans

7.30 Transparency and comparability of business loans are affected typically by some of the same concerns as for BCAs, particularly the absence of effective comparison ratings. However, two additional factors also arise:

- the presence of additional fees, in addition to the interest rate on the business loan product itself
- the loan price is based upon the particular circumstances of the individual applicant, with a significantly more bespoke offer provided in many instances

7.31 The implications of these features are discussed below.

Fee structure for business loans

7.32 There are a number of fees and charges for loans that can take many different forms and vary across providers. This may make it difficult to obtain a total price for a loan, while the possibility of additional fees in certain circumstances can obscure the total price of a loan.

7.33 For example, one bank has noted that, in addition to the interest rates on loans, the prices of its loans are composed of:

- arrangement fees and any early repayment charges, which are subject to negotiation

[194] Based on information provided by the four largest UK banks during the market study.

- fees representing the bank's out-of-pocket costs (such as arrangement fees and fees related to security for the loan), which are not usually subject to negotiation, unless covered by revenue earned elsewhere in the loan agreement

There may also be professional fees in respect of valuation of security.

7.34 There is limited transparency of the full range of fees and charges for loans offered by the largest banks. Some banks, for example, note that fees and charges may only become clear in initial written correspondence about a loan or during the early stages of a discussion with an SME, rather than being advertised upfront. In some cases, the actual fees and charges are also negotiable. This limited transparency, different approaches and multiple charges also appears to make it difficult for SMEs to understand overall loan pricing. It will also make undertaking comparisons across multiple providers time consuming and potentially difficult.

Inherent complexity of pricing and bespoke offers

7.35 Based upon our consideration of the banks' lending policies, we have noted that the methodology employed by each of the banks, as well as their strategic approach, differ noticeably.

7.36 Most large providers employ at least one of a range of different pricing models to determine the acceptability of lending to a particular SME and the cost to do so. We note that some of these models are relatively simple, whereas others are more complex. Most importantly, they all vary in the way in which they assess and combine information on the behaviour, performance and ultimately, the risk presented by a borrowing SME. Moreover, the methodology employed by providers tends to increase in complexity for larger loans, which makes understanding the pricing of loans to these SMEs particularly difficult.

7.37 In addition, the decision-making process regarding loan risk and pricing varies among the larger banks, with some devolving responsibility to local branches, typically for lower-risk and smaller loans, while others use more centralised decision-making with applications submitted to a central credit team for consideration and approval.

7.38 While this is, in many respects, reflective of competition, it does mean that the factors underlying lending decisions will often be unclear to SMEs before they make an application. This limits the extent to which SMEs can assess how competitive the offers are that they receive, even notwithstanding support that banks may provide in helping customers to understand loan offers.

7.39 One reflection of the complexity of loan pricing is the high proportion of bespoke loan rates agreed. As Chapter 8 demonstrates, in the case of two of the large banks, the majority of all customers enjoy bespoke lending rates. In the case of some of the other banks, we observe similar rates with between 30% and 100% of customers enjoying bespoke rates, with one of those banks confirming that all loans above £30,000 are negotiated on a bespoke basis.

7.40 The extensive use of bespoke terms is reflected in the level of public transparency on loan rates. In particular, we note that, with only a few exceptions, there is typically little information in the market on indicative loan pricing from most providers. Moreover, while we understand that some providers plan to introduce calculators to enable customers to receive indicative quotations on business loans, these are often limited and focused upon the smaller loan sizes. [195]

7.41 The complexity of loan pricing arrangements, while sometimes being of benefit to SMEs through bespoke offerings, therefore means that there are significant search costs associated with obtaining multiple quotations for loan products; an SME wishing to make such comparisons would be required to engage in detailed conversations with various providers. In this regard, we note the findings of the review of RBSG's lending practices by Clifford Chance which noted for RBSG that 'there is a great deal of flexibility in the bank's pricing structures, which is to the benefit of customers in many ways, but this flexibility comes at the expense of simplicity and transparency'.[196] We consider that these findings apply across many of the providers in the SME banking sector, with the result that SMEs will not be in a position to drive competition among loan providers.

Service quality transparency and comparability

7.42 During the market study, it has been repeatedly emphasised to us the particular importance of the service element of the relationship between an SME and its bank. For example, one bank highlighted that price was only one of a number of comparators for SMEs, and that for many SMEs, especially at the larger end of the scale, service was more important than price.

7.43 We recognise that service is an important element of the SME banking offering provided by the banks. It is therefore particularly important that, in addition to price, SMEs are able to understand fully and to compare the nature

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[195] We note, however, that some SMEs might use the information on personal loan pricing as a benchmark to assess offers on business loans. However, we have received no specific evidence to demonstrate that this is a benchmark used extensively by SMEs.
[196] Clifford Chance review of RBS's lending practice in the case of businesses in distress, 2014, paragraph 6.13.

and level of the service offering from different banks. Only with this information can they judge how competitive the offer is relative to other offers and thus drive competition between providers.

7.44 In this section, in recognition that an SME is most likely to consider the overall services offered by its bank across various products, rather than in relation to each of the focal products, we have considered the transparency and comparability of the service offered by banks to SMEs more generally.

7.45 With respect to service generally, we recognise that each of the banks provides often detailed information on the features of the services which it offers, both on its website, through staff in branch, and through other promotional information. Indeed, banks providing that information is obviously part of their attempts to obtain and retain customers.

7.46 Moreover, we are aware of certain independent measures of service quality, particularly independent awards granted by various professional bodies for the standard of service offered by the various banks, although we are unclear on the extent to which these are understood or considered valuable by SMEs.

7.47 However, in spite of these mechanisms, SMEs have, historically, not been well placed to understand and evaluate the service offering from different providers, as in many respects this understanding comes from direct experience of using these services themselves. In this regard:

- We note the strongly-held perception among SMEs that all banks are the same, with only limited believed differences between them

- During our focus group research, responses to questions regarding level of service tended to be based on anecdote, brand advertising and personal banking experiences, rather than a more systematic overview of the service offering of different providers

- Historically, few comparison tools have been available which focus on making comparisons between banks on the basis of service parameters. For example, the Business Account Finder does not appear to offer any measure of service quality

The Business Banking Insight

7.48 Indeed, the lack of objective, independent and authoritative information on service levels has been highlighted by the HM Treasury and has led to the creation, by the BCC and FSB, of the Business Banking Insight website.[197] The Business Banking Insight, which was launched in May 2014, provides comparative information on the following service attributes:[198]

- fairness and clarity
- value
- tailoring
- availability
- being informative

7.49 The website allows SMEs to rank providers on their performance under each of these attributes as well as on their overall service rating, based upon a weighted average of all five attributes, with scores out of five also given for a range of other products including loans, insurance and asset finance. SMEs are also able to view feedback from the SMEs interviewed in the survey. Although sample sizes for some providers are low, scores are still presented along with information on how many ratings were used to calculate these scores, leaving it to the SME to decide on how much weight to place on the information presented.

7.50 The results on the website are split into three SME size categories: sole traders, small businesses (with 1 to 9 employees) and medium businesses (with 10 to 249 employees), allowing users to view ratings from the SMEs most similar to themselves. Further, users can view the results by SME turnover size, location and industry sector among other attributes.

7.51 We have seen survey evidence from one large bank that 47% of those SMEs considering switching would be very or fairly likely to consider making changes to their BCA provider if there was an independent website that rated the quality of service from each bank in their area;[199] this could suggest that the Business Banking Insight website has the potential to alter shopping around and switching behaviour. This result was particularly prominent among SMEs that had considered switching in the previous five years, where one in two said that they would be fairly or very likely to consider making changes to their BCA provider as a result of a service quality comparison website.

[197] Available at: www.businessbankinginsight.co.uk.
[198] The findings are currently the result of 5,000 in-depth SME interviews covering 74 bank brands though the survey will be repeated with an additional 10,000 interviews every six months.
[199] Survey provided by a large UK retail bank.

7.52 We therefore welcome the Business Banking Insight, and recognise it as a valuable development in helping SMEs compare providers. [200] However, its effectiveness will depend on whether SMEs use it in sufficient volumes such that providers are driven to improve their service. It is too early to say whether that will, in fact, be the case, although our understanding is that usage has been declining since the publicity associated with its initial launch.[201]

Conclusions on transparency and comparability

7.53 There are significant challenges for SMEs both to understand the cost and service quality provided by SME banking providers, and particularly to compare the offer that they may have with one available from other providers of SME banking services. This reflects some of the complexity, bespoke terms and the 'experience–good' nature of many of the products and services involved.

7.54 While there have been improvements in recent years, particularly the emergence of tariff calculators and the recent Business Banking Insight, unless and until sufficient numbers of SMEs are readily able to understand and make meaningful comparisons both in relation to price and service quality, then it remains unlikely that they will be in a position to drive effective competition between providers.

[200] The OFT, and latterly the CMA, contributed to this as a member of the Advisory Board.
[201] Information provided by one party during the market study.

8. Searching, switching and negotiation

Key facts and findings:

- Only 4% of SMEs switched provider last year – this proportion has been substantially unchanged for a decade and does not vary by size of SME. This is lower than the figures for telecommunications and energy.
- SME take-up of the new seven-day CASS is low: only 7,330 SMEs switched using the CASS in the six months to March 2014 – a very small proportion given that there are over 3.5 million BCA holders, the very large majority of whom are covered by the CASS.
- Fewer than 25% of SMEs shop around for BCAs (albeit more larger SMEs do so). Almost 60% of SMEs spend less than an hour researching providers of lending.
- Around 10% to 20% of SMEs rated the overall standard of service they received from their main banks as poor. Despite this level of dissatisfaction, the annual switching rate remains at 4%.
- A key factor in these low rates of shopping around seems to be the strong belief among SMEs that 'all banks are the same' – over 70% consider that there are no better or only marginally better BCA providers compared to their current provider.
- Around 70% of SMEs seeking loans approach only one provider, without considering alternatives; almost 90% then take out that loan with their main bank.
- There is low SME awareness of alternatives – fewer than 25% of SMEs are aware of peer-to-peer finance, for example, although awareness of these alternatives is greater for larger SMEs.

Introduction

8.1 As we indicate in Chapter 6, markets are most likely to work well when customers are engaged and they can and do act on information to ensure that they get the best possible deal. This dynamic is the essence of how customers drive competition and create stronger incentives for providers to compete effectively against one another.

8.2 This is because the more shopping around and switching that takes place between providers, the stronger are providers' incentives to compete to retain and win customers. We recognise that it is not necessary for *all* customers to switch in order to drive competition among providers. If a sufficiently significant proportion of SME customers switch, or credibly threaten to switch, this could be enough to act as a competitive constraint on the banks and to protect those SMEs that do not switch. Moreover, actual switching is only one way in which SMEs provide a competitive constraint on the behaviour of banks. SMEs might instead negotiate over price and elements of the service offered, or shop around and not switch due to their current provider already offering them the best deal for their circumstances. Instead, what is important is that SMEs show significant engagement with their banking providers, are able to shop around effectively and, should they wish to switch, face low barriers to doing so. Levels of switching are *indicative* of this, but they must be viewed in conjunction with other factors such as the extent and ease of shopping around, the ease of switching and the availability of outside options.[202]

8.3 In this chapter we consider the extent to which SMEs are undertaking search activities to compare alternative providers of BCAs and business loans, and then the extent of negotiation. We then examine the level of switching that takes place in the sector and the reasons that SMEs choose to switch their bank as well as reasons for not switching. We then consider the effect of the CASS. Finally, we examine other ways in which SMEs may be able to drive competition among providers other than switching.

8.4 We start, first, by considering previous studies of SME behaviour.

Previous studies

8.5 Concerns about limited rates of shopping around and barriers to switching in SME banking have been expressed in various previous competition studies of the sector:

- The CC inquiry found that SMEs were reluctant to switch banks, partly because of the perceived complexity of switching for little financial benefit and partly because of the perceived importance of maintaining long-term relationships with their bank.

- The OFT in 2007 noted that switching rates remained around 4% per year and remained restricted by a lack of transparency, the length of the switching process itself and difficulties faced by SMEs in switching provider.[203]

- The ICB report noted that low switching rates were a feature of the BCA market, with switching rates for retail banking lower than in many other

[202] In economic terms, the outside option is the next best alternative or business proposition of buyers in case their negotiations with a given supplier break down. Intuitively, buyers with a good outside option can negotiate a good deal because they have a credible and favourable alternative to choose from if the negotiations break down. As such, they can ‘leave the negotiating table’. In contrast, buyers with no outside option, or a poor one, will have to accept a worse deal because their bargaining position is weak.
[203] OFT (2007).

sectors.[204] To address these concerns, the ICB recommended that the Payments Council introduce a free current account redirection service (across both personal and SME customers). This recommendation subsequently led to the introduction of the CASS, which we discuss later in this chapter.

Searching activities

8.6 As we describe above, customers play a central role in driving competition between providers through their willingness to search for (and, implicitly, to threaten to switch to) another provider, which offers them a better deal. The level of shopping around can therefore provide an important indication of the extent to which SMEs are, in practice, driving such competition. In this section, we present the evidence we have obtained on this issue. We do so first by reference to general SME search behaviour for BCAs, after which we consider their search behaviour at the start of the business banking relationship when first opening a BCA. We then consider shopping around for loan products.

General SME search behaviour for BCAs

8.7 The evidence obtained during the market study shows that very few SMEs shop around for BCAs. Around 80% of smaller SMEs reported rarely or never shopping around, a proportion that dropped to 72% for larger SMEs (see Table 8.1). Qualitative research has also found that SMEs changing banks undertake very little searching before opening a BCA with another provider.[205]

[204] See ICB (2011), Final Report, Figure 7.4, p183.
[205] Charterhouse, Q3 2013, concluded that businesses are typically fairly reticent to switch banks and when they do switch very little shopping around for the new bank account takes place. This was based on 25 depth interviews with SMEs with under £1 million turnover. Five out of the 25 businesses interviewed had switched their main banking relationship. Just one respondent approached more than one bank. One further respondent asked their accountant's advice.

TABLE 8.1 **How often SMEs search for a better main BCA provider***

	Turnover less than £99,999	*Turnover £100,000–£1m*	*Turnover over £1m*
Base	666	395	242
			%
Frequently (we look out for better offers all year round)	2	3	4
Occasionally (we look for better offers a few times a year)	7	8	8
Probably only around once a year	9	9	12
Rarely (we have looked at new providers once or so in the past three years)	28	37	45
Never (we always stick with our existing provider)	53	43	27
Don't know	2	1	3
Total	100	100	100

Source: 2013 YouGov SME Banking survey, excluding SMEs who only conduct business banking through a PCA.

*The survey defines SMEs as businesses with less than 249 employees and a small number of respondent SMEs may have greater than £25 million turnover. This will not materially affect the proportions. SMEs in their first year of trading excluded from the turnover results.

Start-ups: choosing a BCA provider for the first time

8.8 In addition to SMEs' general behaviour, we note that start-ups which are setting up their business banking relationship for the first time undertake little shopping around and comparative analysis when choosing their BCA. The OFT found that only two-fifths (42%) of SMEs under two years old claimed to have sought information from other banks and building societies when choosing a bank, a proportion that has not changed since 2000 (43%).[206] In many instances, a customer defaulted to approaching their PCA provider when seeking a BCA.

8.9 Indeed, for start-ups, it is the case that the most important single factor in influencing their decision as to who to obtain their BCA from was their existing relationship with a PCA provider, consistent with previous surveys of the sector. For example, and as shown in Table 8.2, between 29 and 44% of start-ups reported that a personal banking relationship influenced the choice of BCA provider. This is broadly consistent with our findings in Chapter 4 about the importance of the PCA as a 'gateway product' for BCAs.

[206] OFT (2007), Annex B, paragraph 1.10.

TABLE 8.2 **Reasons why SMEs chose their BCA provider – comparison across surveys of main responses**

%

	Charterhouse Business Banking Survey 2013 (start-ups)	*YouGov – SME Banking 2013 (start-ups)**	*YouGov – SME Banking 2013 (turnover under £100,000)**	*YouGov – SME Banking 2013 (turnover £100,000 to £999,999)**	*YouGov – SME Banking 2013 (turnover over £1 million)**	*Datamonitor (2012)†*	*OFT – Barriers to Entry in Retail Banking 2010*	*OFT – Review of undertakings 2007**
The owner/I already had a personal account with them	29	44	46	35	26	41	35	34
Location/closest bank to business	15	14	16	17	17	8	27	17
Recommendation	13	7	5	7	7	11	17	3
Offered best prices	19‡	14	19	14	14	4, 9§	22	13
Offered best services	N/A¶	15	12	13	19	6, 7#	N/A	10
Free banking	N/A¶	32	19	15	12	<1	N/A‡	5
Offered the services we required	N/A~	22	20	26	29	<1	45	8
It had a strong reputation	1	6	8	9	15	<1	25	5
Quality of relationship with manager	3	1	3	10	17	<1	25	3

Source: Charterhouse (2013), YouGov (2013), Datamonitor (2012), OFT (2010), OFT (2007)

*Base excludes SMEs who only use a PCA to conduct business banking to aid comparability with other surveys in this table (Charterhouse and OFT surveys). We note the low number of start-up respondents to this question (87).
†Question asked for the main reason for choosing provider so multiple responses cannot be given unlike the other surveys.
‡Charterhouse survey combines 'free banking/had a good offer' as one response. Similarly in the OFT 2010 survey where respondents who chose a bank on the basis of free banking would be included in the 'offered best prices' category.
§Different responses related to price, eg more flexible with fees and charges (9%), attractive interest rates (4%).
¶Different responses related to service, eg good/better customer service (2%), helpful staff (2%), easy online banking (1%).
#Different responses related to service, eg better online banking services (7%), bad experience with previous bank (6%).
~No responses relating directly to this category although the survey found that 6% chose the account because the bank was willing to finance the business.

Notes:
1. The reasons include the top five reasons from each source, other than Charterhouse, where the top five reasons also include 'the bank showed interest in having my business' (12%).
2. Base is all those who have had an account for ten years or less.
3. The higher response rate for 'offered the best services' in the 2010 OFT survey can be attributed to differences in the method of questioning. Respondents to the OFT 2010 survey were provided with suggested response categories that may have influenced the way in which the SME replied. The other surveys (except Datamonitor) relied on the spontaneous responses of the respondent.

8.10 The impact of the personal banking relationship is consistent with our qualitative research which found that, for many start-ups, finding a BCA provider is a quick decision or an afterthought given other pressures, with shopping around not being the norm. Indeed, seeking a BCA from the existing PCA provider tends to be seen as the logical thing to do given that it is seen as simpler and easier to do than going elsewhere,[207] and that the PCA provider is already well known to the SME. Some SMEs thought that if their bank, with access to their personal records, would not give them a BCA, then no other bank would.[208]

8.11 This evidence tends to suggest that, even for those SMEs without an existing business banking relationship, shopping around is still relatively limited, with their incumbent PCA provider likely to hold a 'first port of call' advantage over other providers.

Searching for lending

8.12 The majority of SMEs (particularly smaller SMEs) do not currently have external finance and rely instead on retained earnings.

8.13 However, for those SMEs that do seek external finance, the evidence we have obtained shows that most undertake little search activity, approaching few providers and devoting little time to the process:

- The majority of SMEs (71%) approached only one provider on the last occasion they sought finance.[209] Of these, only 3% said that they had previously shopped around and found them to offer the best deal prior to approaching a single provider.

- SMEs tended to spend very little time shopping around, with research showing that almost 60% of SMEs that shop around spend less than an hour considering their financing options.[210]

[207] For example, where the SME owner holds a PCA, the bank may not require proof of ID and therefore it might be easier and quicker to process the application.
[208] BDRC focus group research, slides 25 to 30.
[209] BMG (2013). This survey covered all sizes of SMEs, with SMEs defined as having less than 250 employees. Data was weighted by size, industry and age using BIS Business Population Estimates. It is not possible to tell from the survey question whether the provider that the SME approached was its existing BCA provider. BMG (2013); 11% contacted two providers, 7% three, 5% four and 4% five or more.
[210] BMG (2013), p32.

8.14 Similarly, the evidence indicates that most SMEs whose loan is renegotiated by their bank do not shop around for a better deal at the point of re-negotiation.[211]

8.15 Much like the pattern we observe in relation to the linkages between choice of PCA and BCA provider, the vast majority of SMEs approach their BCA provider when seeking a loan. This is apparent from survey information, where 88% of SMEs reported approaching their main BCA provider first when trying to obtain a loan.[212] This is consistent with the evidence we have seen as to the very high actual proportion of SMEs which take out a loan at a provider where they hold a BCA, as we demonstrate in Table 8.3. It is also consistent with our focus group research which shows that the BCA provider is the first port of call for most SMEs.[213]

TABLE 8.3 **Proportion of SME business loan customers at each of the largest four banks also holding a BCA with that bank**

	%
Barclays	[✄]
HSBC	[✄]
Lloyds	[✄]
RBSG (E&W)	[✄]
RBSG (Scotland)	[✄]

Source: Information provided by the banks.

8.16 Despite this pattern, some important distinctions in search activity can be observed depending on the size of the SME. We consider these in the next section.

How searching for loans varies by size of SME

8.17 The evidence, presented in Table 8.4 below, demonstrates that most smaller SMEs tend to approach only one provider when seeking a loan. However, larger SMEs are more likely to shop around, with over 60% approaching more than one provider. There remains, however, a significant minority of larger SMEs which only approached one provider.

[211] Only 13% looked for an alternative provider, even though around a third (31%) of those that did shop around moved their loan to a new bank and appear to have got a better deal. SME Finance Monitor survey, Q1 2011–Q2 2013. We note that this is based on a low number of respondents and therefore do not place reliance on the actual percentages.
[212] SME Finance Monitor report, Q2 2013, p92.
[213] BDRC focus group research, slide 64.

TABLE 8.4 **Number of providers SMEs approached, by number of employees**

Number of providers approached	*Total Base 588*	*Sole traders Base 141*	*Micro (2–10) Base 267*	*Small (11–50) Base 105*	*Medium (51–250) Base 75*
					%
Just one	71	75	66	57	34
Two	11	10	10	19	30
Three	7	4	10	14	17
Four	5	4	5	7	6
Five or more	4	5	3	*	9
Don't know/refused to say	2	1	5	2	4
Mean	1.57	1.53	1.6	1.7	2.24

Source: SME Journeys towards raising External Finance, BMG/BIS 2012.

Base = all who have sought finance in the last 3 years (n=588).
*A figure greater than zero.
Note: The percentage shown under 'Total' is calculated using a population weight and cannot be derived using the figures for Sole traders, Micro, Small and Medium SMEs.

8.18 Lower rates of shopping around among smaller SMEs may reflect a lack of confidence in approaching different lenders. This is consistent with research conducted by the research agency Quadrangle in 2013 which found that 42% of surveyed SMEs agreed that they felt confident approaching different lenders for funding.[214] This proportion increased to around 60 to 62% for SMEs with a turnover of over £5 million.[215]

Advisers and intermediaries

8.19 SMEs may choose not to engage in search activities themselves, potentially using advisers or intermediaries to avoid some of the costs associated with searching.

8.20 However, consistent with the preference of many SMEs to approach their BCA provider when seeking to obtain finance, some 84% of SMEs did not obtain any external advice when applying for finance.[216] This limited usage of external advice is consistent with other evidence we have seen:

- In qualitative research conducted for BMG, most businesses had not sought any advice, with only a few speaking to their accountants. Most reported that they would not be willing to pay for such external advice.[217]

- The National Association of Commercial Finance Brokers submitted evidence that the use of brokers tends to be focused on SMEs with employees, rather than sole traders. It also noted that awareness of brokers among SMEs was limited.

[214] Scoring 8–10 from a scale of 1–10.
[215] Quadrangle (2013)a, slide 25.
[216] BMG (2013).
[217] BMG (2013).

- An InterTradeIreland report raised concerns that in Ireland (including Northern Ireland), 'the majority of intermediaries involved in advising SMEs are not adequately familiar with the bank application process, conditions and structures'.[218]

8.21 While we consider that there is an important role for external advisers and intermediaries in helping SMEs to obtain the best possible deal, the evidence indicates that, at the present time, intermediaries play only a limited role in providing advice to SMEs. Where they do so, it tends to be confined to providing advice to larger SMEs on particular product lines, such that their overall impact on competition is limited.

Conclusion on search activity

8.22 The available evidence indicates that, with the exception of the largest SMEs for lending products, most SMEs engage in limited search activity, whether directly themselves or indirectly through using the services of advisers or intermediaries. Indeed, most SMEs use suppliers with whom they have an existing relationship.

8.23 This paucity of search activity is likely to limit switching, which in turn is likely to diminish the incentives for providers to compete intensely in order to ensure that they are providing their customers with the best possible deal.

Buyer power and negotiation

8.24 As an alternative to switching, SMEs might negotiate over prices and other elements of the service offered by their existing provider, providing an incentive for providers to compete by improving their offering. This will not be reflected in the level of switching in a market nor by changes in the level of switching.

8.25 Evidence on SMEs' ability to negotiate will include the extent to which SMEs consider themselves well placed to negotiate successfully with providers and the prevalence of bespoke terms for SMEs.

8.26 However, our focus group research found that most SMEs consider that they have little or no negotiating power when dealing with banks, with their prices typically being fixed. It is only as the size and complexity of the business increases that SMEs considered that they could negotiate and threaten to switch with credibility.[219] This is consistent with evidence from the YouGov

[218] Access to Finance for Growth on the Island of Ireland (2013), p68.
[219] BDRC focus group research, slides 16, 18 & 36.

2013 SME Banking survey (see Table 8.5), which shows that fewer than one in ten smaller SMEs attempted to negotiate at least one BCA charge or lending within the previous year. This increases to one in five among SMEs with a turnover of between £100,000 and £1 million, and two in five among SMEs with a turnover greater than £1 million. However, of those that do attempt to negotiate, success rates seem relatively high, at around 70%, and do not differ considerably between smaller and larger SMEs.

TABLE 8.5 **Proportions of SMEs attempting to negotiate on at least one of their BCA, loan or overdraft charges or interest in the previous year**

	Proportion that attempted negotiation	*Success rate*
Less than £100,000	9	69
£100,000–£1m	20	70
More than £1m	39	75

Source: YouGov 2013 SME Banking Survey.

8.27 This pattern of negotiation is also reflected in the incidences of bespoke terms offered by providers, either to meet competition or to otherwise ensure that their pricing reflects the particular circumstances of the SME in question. As shown in Tables 8.6 and 8.7, bespoke terms tend to be applied more frequently in relation to the largest SMEs, at least in relation to BCAs.[220]

TABLE 8.6 **Proportion of SMEs with bespoke BCA pricing terms**

Provider	*Below £2m turnover*	*Above £2m turnover*	*Total*
NatWest	[✂]	[✂]	[✂]
RBS Scotland	[✂]	[✂]	[✂]
RBS England & Wales	[✂]	[✂]	[✂]
Lloyds Banking Group	[✂]	[✂]	[✂]
Barclays	[✂]	[✂]	[✂]
HSBC	[✂]	[✂]	[✂]
Ulster Bank	[✂]	[✂]	[✂]
Danske bank	[✂]	[✂]	[✂]
Bank of Ireland	[✂]	[✂]	[✂]

Source: Information provided by banks.

[220] Banks may choose to offer pricing which differs from their standard terms as an initial offer to SMEs, without necessarily entering into negotiation with SMEs. Therefore the SMEs identified as negotiating or attempting to negotiate bespoke terms will be lower than what the banks have provided to us.

TABLE 8.7 **Proportion of SMEs with bespoke loan pricing terms**

	Below £2m turnover	*Above £2m turnover*	*Total*
RBSG E&W	[✂]	[✂]	[✂]
RBSG Scotland	[✂]	[✂]	[✂]
Lloyds	[✂]	[✂]	[✂]
Barclays	[✂]	[✂]	[✂]
HSBC	[✂]	[✂]	[✂]
Danske Bank	[✂]	[✂]	[✂]
Bank of Ireland	[✂]	[✂]	[✂]

Source: Information provided by banks.

8.28 However, for the largest SMEs, it is not clear that the widespread use of bespoke terms provides a conclusive indication of the extent of their negotiating power among larger SMEs. This is partly because pricing for BCAs and loans to larger SMEs is often bespoke as the costs and risks involved in serving these SMEs may vary significantly rather than being a reflection of the negotiating strength of the SME. Moreover, concerns regarding barriers to switching, particularly in secured lending, are likely to be a more significant concern for the largest SMEs. This may, in turn, reduce the credibility of any threat to switch and consequently the extent of their bargaining power.

8.29 While the evidence of negotiation suggests that competitive constraints may be somewhat greater than the switching rates on their own suggest, negotiation tends to be particularly focused on a small minority of the largest SMEs, thereby limiting its effect on competition overall.

Switching

8.30 Following the examination of search behaviour among SMEs in the preceding section, this section examines the ways in which SMEs can 'discipline' providers directly by actual switching – ie moving their BCAs and loans to alternative providers offering a better deal, thereby giving providers strong incentives to compete effectively in order to retain customers.

8.31 In this section we focus on BCAs rather than business loans. This is because business loans, given their generally short-term nature, are generally less likely to be subject to switching. However, we do consider the impediments to switching lending products below in relation to the largest SMEs, where an SME may have several high-value lending products, making switching more viable.

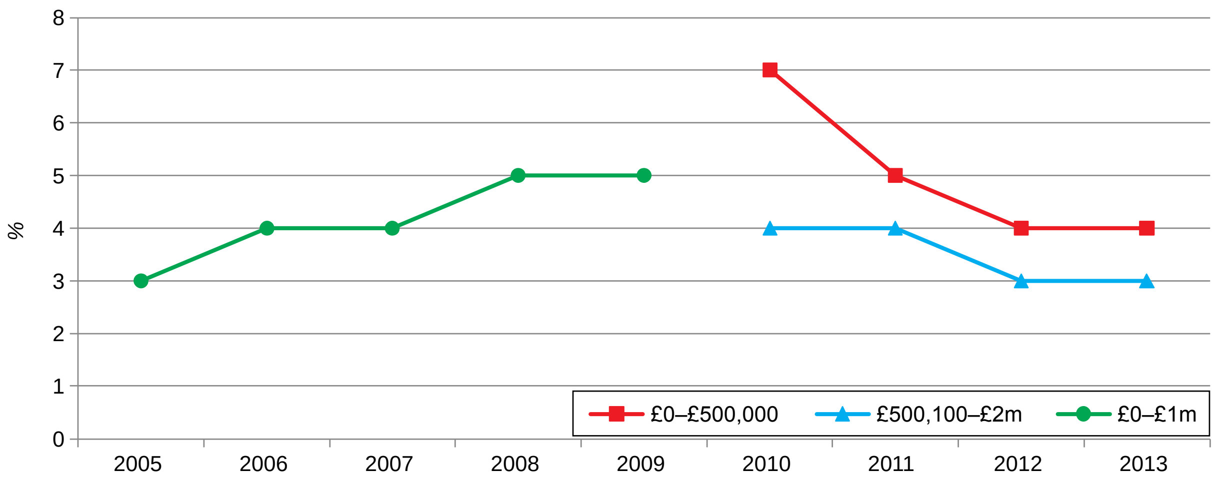
Levels of switching of BCAs

8.32 Shopping around and considering switching are important precursors to switching. As we found above, shopping around remains very limited, meaning that most SMEs are unlikely to be aware of better offers. Indeed, if they switch without shopping around, they risk not obtaining the best available product for them.

8.33 Based on information received during the market study, and consistent with long-term trends in the sector, the proportion of those SMEs which actually switch BCA provider remains very limited. Indeed, various surveys put that figure at around 4% annually, a figure which one of the largest bank's internal documents emphasises has persisted over ten years. Moreover, the switching level does not vary significantly by the size of SME (with only 4% of the largest SMEs switching their main banking relationship in 2013). The annual rate of switching is illustrated in Figures 8.1 and 8.2 below.[221]

FIGURE 8.1

Annual switching rates for main bank provider over time – smaller SMEs



Source: 2010–2013 Charterhouse Business Banking survey question B4a *Have you changed your main banking provider in the past 12 months?* Survey covers Great Britain. All figures for year ended Q3 save for 2010 which is for Q1–Q4 2010. 2005–2009 from Figure 7.3 of ICB final report covers drawn from the TNS RI Small Business Banking Survey in Great Britain.

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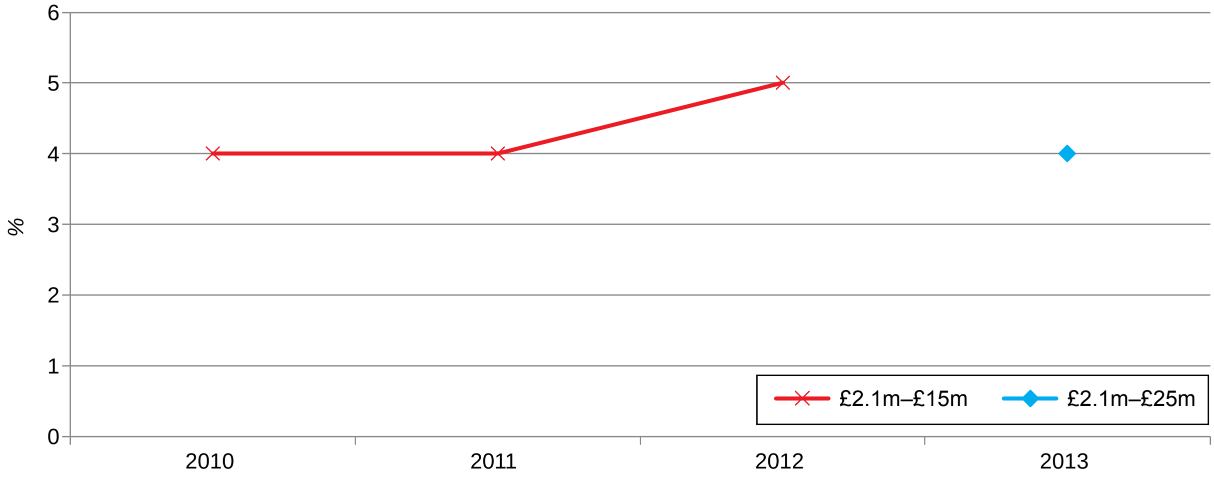
[221] The FSB Voice of Small Business Survey Panel, August 2013, found that the annual switching rate varied between 4% for sole traders and 6% for SMEs with greater than 50 employees (based on a very small sample of 28).

FIGURE 8.2

Annual switching rates for main bank provider over time – larger SMEs



Source: 2010–2013 Charterhouse Business Banking survey question B4a *Have you changed your main banking provider in the past 12 months?* Survey covers Great Britain. All figures for year ended Q3 save for 2010 which is for Q1–Q4 2010.

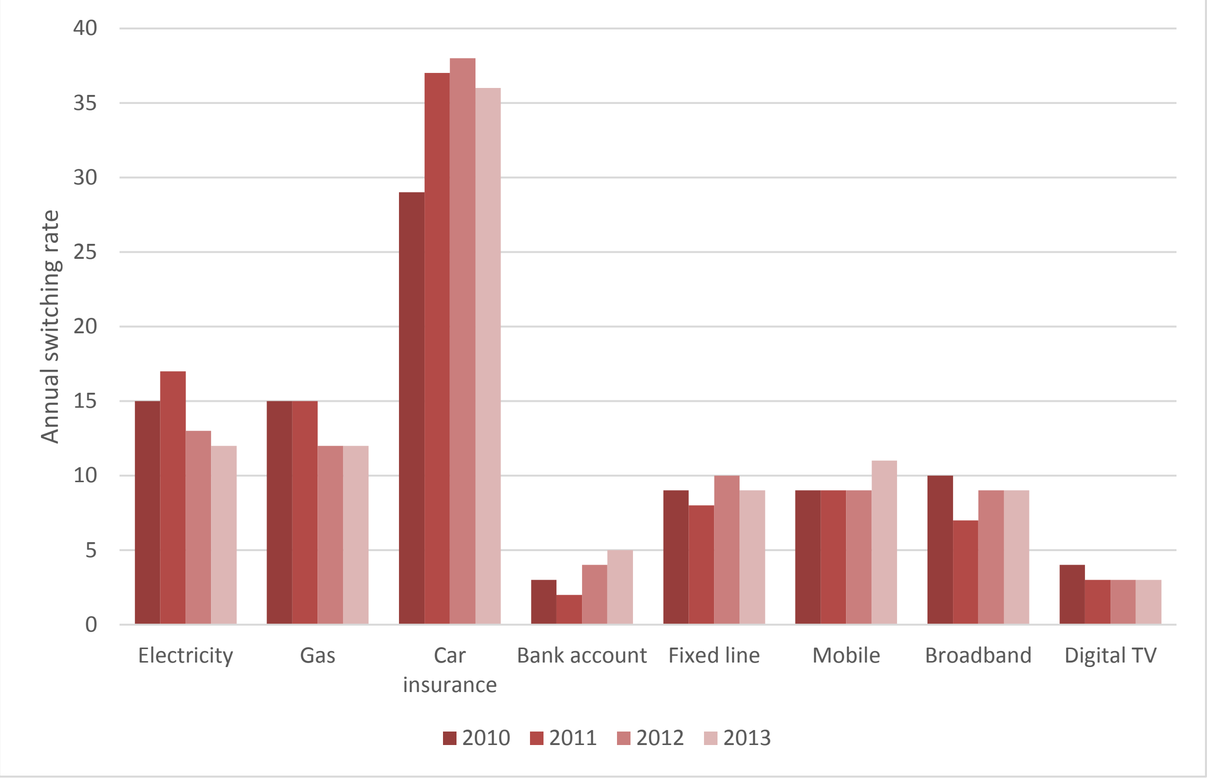
8.34 A similar pattern can be seen in relation to BCAs with overdrafts, where SME Finance Monitor research found that few SMEs with an overdraft facility switch their BCA and accompanying overdraft (with less than 4% doing so over the previous 12 months).[222] 16% of SMEs shopped around in response to having the terms of their overdraft renegotiated by their provider, but less than 2% moved to another bank.[223]

8.35 These switching rates in retail banking are much lower than in many other markets including energy provision, car insurance and mobile telephones, as we demonstrate in Figure 8.3 below.[224]

[222] CMA/FCA analysis using SME Finance Monitor survey data covering Q4 2011–Q2 2013. We note that it is not clear whether this includes SMEs which have an overdraft facility but make no use of it.
[223] SME Finance Monitor Survey for Q1 2011–Q2 2013. 143 respondents searched for another provider in response to having their overdraft renegotiated.
[224] See Ofcom Consumer experience of 2013, Figure 145, p141.

FIGURE 8.3

Annual switching rates in banking, communications and utilities



Source: Ofcom, Consumer Switching Report, August 2013. Ofcom decision-making survey carried out by Saville Rossiter-Base in July to August 2008, 2009 and 2010, June to July 2011, July to August 2012.

8.36 In the next section we consider some of the possible reasons for the low levels of switching we observe, particularly the extent to which there are actual or perceived barriers to switching (or switching costs). Such switching barriers and costs are likely to mean that providers have fewer incentives to compete effectively given the 'stickiness' of their customer base. We start first by considering SMEs' views about the switching process.

Views about the switching process

8.37 For SMEs to switch to a more competitive offer from a different provider, the believed benefits of doing so need to exceed both the believed and actual costs of switching. This section explores this issue further.

8.38 The overwhelming evidence that we have received during the market study indicates that SMEs tend to be 'pushed' to switch in response to experiences of poor service (and to a lesser extent concerns about price) rather than by being 'pulled' by a more attractive offer from a competing bank. In particular:

- Charterhouse indicates that, among SMEs that switched, the proportion of SMEs stating that a poor relationship with their old provider prompted their switch was 34% in 2013[225]

- The Charterhouse qualitative evidence we have seen found that push factors such as poor service or branch location were most influential in influencing the decision to switch 'rather than a proactive decision based on pull factors from new banks'[226]

- Research by Quadrangle found that 'there is near, as possible, universal agreement that unless the basics are wrong there is little point in even considering a switch'[227]

- Various of the SME representative organisations have submitted to us that SMEs only switch when they suffer a particularly bad service experience, which can include the loss of an experienced relationship manager

- The Payments Council's qualitative research, covering both personal and business customers, found that perceived poor service had been the initial motivation for switching from the old bank[228]

8.39 The available evidence tends to suggest that, in the limited number of occasions where an SME does switch, the decision to do so is predominantly in response to significant concerns on the part of the SME with the performance of its existing provider, rather than being part of a periodic consideration by an SME of their relationship with a bank. We consider why this is the case below, where we consider barriers to switching.

Barriers to switching

8.40 In this section, we consider the nature and extent of any barriers to switching, both actual and believed, which may mean that SMEs are less willing to switch, or even consider switching.

8.41 There are a number of factors that may limit the level of switching and consequently reduce the competitive constraint exercised by SMEs on the providers of BCAs and loans:

[225] According to Charterhouse (year ended Q3 2013).
[226] Charterhouse Research, Q3 2013, Qualitative research.
[227] Quadrangle (2013)a, slide 30.
[228] The Payments Council's qualitative research, which covered both personal and business customers, found that perceived poor service had been the initial motivation for switching from the old bank. See OPTIMISA research 'Current Account Switching: The Proposed Seven Day Switching Service', December 2011, p14.

- If there is a belief among a number of SMEs that there is a lack of differentiation among providers, limiting their inclination to switch (as well as their willingness to shop around)

- If there are significant costs associated with switching, either actual or believed, and these may outweigh the benefits. This is particularly relevant where an SME has existing borrowing

- If some SMEs believe that there is value to maintaining a long-standing relationship with their banking providers; this belief could arise from:

  — the relationship built up with a provider

  — information asymmetries, such that the provider has greater knowledge of the SME's business

8.42 The following sections explore these potential barriers in more detail.

Believed lack of differentiation among providers

8.43 During the market study, one of the most frequent comments we have heard from SMEs and their representatives is that the banks are all believed to be much the same. This was particularly apparent in our focus group research, as demonstrated by the quotations from various SMEs shown in the box below. Quadrangle also found that 'SMEs voiced a lot more frustration around the lack of perceived differentiation in the market place than transparency around the specific issue of costs'.[229] Charterhouse research on SMEs with under £1 million turnover also found that 'Bank service typically considered much of a muchness [by SMEs]: very little differentiation between the major banks'. The research found that 'switching itself is perceived as a lengthy, disruptive process with no guarantees of better service or support from the new bank'. and 'push factors such as poor service [are] most influential in the decision to switch rather than a proactive decision based on pull factors from the new banks' and so SMEs 'need a strong trigger to consider switching'.[230] A number of SME representative organisations also reported that many SMEs believed that the largest banks were similar or the same, as did various SMEs at a London roundtable we attended which was facilitated by the Institute of Directors.[231]

[229] Quadrangle (2013)b, slide 26.
[230] Charterhouse, Q3 2013, Qualitative Research.
[231] Various meetings with SME representative organisations. The roundtable we refer to above was held on 20 February 2014.

Quotations from SME participants in the CMA's qualitative research commissioned from BDRC focus group research

'There are few perceived benefits (financial or otherwise) as all banks are the same.'

'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.'

'They are all the same. The only way that will ever change, really, is if you had smaller banks coming along, they could offer a different service.'

8.44 This is consistent with quantitative evidence we have received. 72 to 79% of SMEs surveyed by YouGov in 2013 considered that there were probably no better or only marginally better alternative main BCA providers.[232] Research provided to us by one of the UK's largest banks also found that among the main reasons for not switching BCA providers was that other offers were too similar to the existing offer they received.[233] Research by the Forum of Private Businesses also found that one of the top two reasons for not switching was that businesses believe there is no real difference between banks, so there is no reason to change.[234]

8.45 However, according to qualitative research, larger SMEs tend to have a greater awareness of and interest in providers other than the major high-street banks, with such alternative providers being viewed as having the potential to offer new options and alternatives to existing providers.[235] This may provide larger SMEs with a greater number of credible outside options and may afford them greater bargaining power than smaller SMEs.

Costs of switching

BCAs

8.46 The evidence we have received indicates that many SMEs consider the process of switching BCA provider to be costly or risky or both. In particular, during the market study we have heard concerns about:

232 CMA/FCA analysis of YouGov 2013 SME Banking survey, figures excluding SMEs in their first year of trading.
233 46% of SMEs considering switching said that the reason why they had not switched was that other offers were too similar to the existing offer. Survey data provided to the CMA by a major bank.
234 'Cash Flow and Finance Panel Report', Forum of Private Business, June 2013, reports that 26% believe there is no real difference between banks so no reason to change (p13). Report based on the views of the FPB Cash Flow and Finance panel comprising of 80 members.
235 BDRC focus group research, slide 22, notes that there is 'Greater interest in these [new entrants / smaller banks] among the large SMEs who see it as "shaking up the market"'. BMG (2013) notes that larger SMEs (those with 51–250 employees) tended to be the most aware of each type of a range of finance sources, including peer-to-peer financing and invoice lending.

- the need for an SME to contact its customers with the new bank's details and get long-standing customers to update their records and pay the new bank[236]

- the risk that errors would be made in transferring direct debits, standing orders and other payment authorisations

- the switching process resulting in delayed or missed payments, a specific factor inhibiting switching for some SMEs, according to the qualitative evidence[237]

8.47 One representative organisation also told us that SMEs were experiencing 'significant difficulties' with switching, which, in some cases, had taken longer than expected and had required the SME to do the 'legwork'.

8.48 The quantitative evidence is somewhat more mixed. Survey evidence submitted to us by one of the large banks indicates that, among those SMEs considering a switch, 53% said that at least one of the reasons they had not switched was due to believed problems with the switching process, with 28% considering it would take too much time and 31% considering it would be too much 'hassle'.[238] The Forum of Private Business found that one of the main reasons that SMEs did not switch was the problems involved in changing banks – 24% reported it would be too much 'hassle'.[239] This suggests that, for many SMEs, negative beliefs about the switching process remain as a significant barrier to switching.

8.49 For those SMEs which have switched, the evidence we have seen indicates that some SMEs that switched did not find the process easy. The FSB's 2013 survey found that, of the 93 respondent SMEs that had switched in the previous year, 27% had found the switching process very difficult or fairly difficult.[240] YouGov 2013 found that around 38% to 46% (depending on SME size) had found switching difficult or very difficult.[241] Larger SMEs were less likely to report that switching was difficult than smaller SMEs though 38% of these still reported problems.

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[236] BDRC focus group research, slide 76. Some SME participants at the IOD–OFT roundtable held on 20 February 2014 also said that the need to notify customers of new account details was a barrier to switching.
[237] BDRC focus group research, slides 75–76.
[238] These two figures do not sum as respondents were able to give multiple responses.
[239] 'Cash Flow and Finance Panel Report', Forum of Private Business, June 2013, p13. Report based on the views of the FPB Cash Flow and Finance panel comprising 80 members.
[240] 'FSB Voice of Small Business Survey Panel' report, August 2013. Research findings are based on a survey made available to the FSB 'Voice of Small Business' Panel during 31 July to 12 August 2013 (2,330 respondents).
[241] Excluding 'didn't know' responses.

8.50 We consider that there is scope for the CASS to go at least some way to addressing certain of the actual and believed costs of switching referred to above. Indeed, it has been successful from an accuracy and operational perspectives, with 99% of switches being completed within the seven working day timescale.[242]

8.51 We note that much of this analysis is based on evidence obtained prior to (or shortly after) the introduction of the CASS, and that the CASS may help reduce both the actual and believed costs and risks in the switching process. We consider this point further below.

The impact of existing lending

8.52 For SMEs seeking to switch provider, the presence of existing loans, particularly those secured on the business or other assets, make the switching process more complex, expensive and slow, as the new provider needs to agree to take on the security from the existing provider. Given the greater propensity of larger SMEs to engage in borrowing, this issue is likely to be of greater salience to those SMEs.

8.53 During the market study, we have seen evidence that this continues to be a barrier to switching for at least some SMEs:

- Our qualitiative research found that some larger, more complex businesses find it costly to switch secured borrowing and that existing borrowing was felt to be a barrier to switching[243]

- Survey evidence provided to us by one of the large banks indicated that, among those considering switching, 19% of SMEs surveyed reported that existing finance meant that it would be hard/difficult to move.[244] Albeit this is not a high figure in itself, the fact that a majority of SMEs do not obtain external finance indicates that for those that do so, this factor is of particular significance

8.54 Although SMEs have the possibility to switch BCAs while keeping their term loans with their existing provider, the evidence above indicates that those SMEs with existing lending and accompanying security may believe that it is

[242] Source: Payments Council CASS dashboard, published April 2014. This describes the time to switch using CASS metrics, and does not take account of the account-opening process. Most large banks can generally supply Internet banking and debit cards within the seven working day time frame should the customer bring all paperwork required by the bank into the branch in one go. However, there may be delays in receiving all relevant documentation which could increase the overall time taken to switch.
[243] BDRC focus group research, p83.
[244] Survey evidence provided by one of the largest UK banks.

more difficult to switch. This belief may provide a barrier to switching loans or other products.

Long-standing relationships with banking providers

8.55 We have been informed, consistent with the CC inquiry's analysis of the market, that many SMEs consider that a long-term relationship with their banking provider is important to obtaining financial support. This may reflect the value that some SMEs place on their relationship managers or the view that their main bank is likely to hold sufficient information to enable them to take more favourable lending decisions. There may also be a more emotional element where an SME which has demonstrated loyalty to a bank expects that loyalty to be reciprocated in one form or another by that bank.

8.56 This is consistent with quantitative evidence we have received during the market study. Research by Quadrangle indicates that 52% of SMEs with turnovers of £0 to £99,000 and £100,000 to £999,000 thought that staying with a provider was a 'good thing'. However, this proportion fell to 43% for SMEs with a turnover of £1 million to £9.9 million and 44% for SMEs with a turnover of £10 million to £25 million.[245] The Forum for Private Business also found that some SMEs have concerns over whether they would be able to access overdraft facilities without having a history with the provider.[246] Finally, we have received survey evidence from one of the UK's largest banks which indicated that 36% of SMEs which had considered switching said one reason for not switching was that they would lose the benefit of a track record with the bank.[247]

8.57 This evidence is also consistent with the submissions of various banks during the market study:

- One large UK bank submitted that BCA tariffs were not the sole consider-ation for SMEs. The relationship between an SME and the bank in question was also important. For instance, an SME customer may have borrowing or other banking needs in the future and would want to feel confident that its chosen bank would support it.

- Aldermore submitted that:

> if there is a great relationship between a bank and an SME, the SME will be very reluctant to switch to a new relationship

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[245] Quadrangle (2013)a, slide 30.
[246] Source: 'Cash Flow and Finance Panel Report', Forum of Private Business, June 2013, p2. Report based on the views of the FPB Cash Flow and Finance panel comprising 80 members.
[247] Survey evidence provided by one of the UK's largest banks.

manager given the investment in ensuring the relationship manager understands and can be an advocate for a business. Switching is even avoided within the same bank, so some customers will stay with their relationship manager even if the manager changes location.[248]

8.58 We understand that in many cases this SME belief is firmly grounded in the bank's actual decision-making process. Many banks do use information about the SME from the BCA to help them with their credit assessment, a point made to us by several of the banks.

Initiatives to facilitate switching current accounts

8.59 Given the concerns about both actual and believed difficulties in switching in relation to current accounts, there have been a number of initiatives to improve the switching process, most particularly the introduction of the CASS (see the box below).

The Current Account Switching Service

The CASS was launched on 16 September 2013 for use by individuals and small businesses with up to ten employees and with a turnover of less than €2 million or a balance sheet total of less than €2 million. Thirty-three banks and building society brands participate in the CASS, covering the entire current account marketplace.

A small number of slightly larger SMEs may be able to use the CASS to switch current accounts as the service is able to move high-value current accounts. However, the Payments Council has not included larger businesses within the target customer base.

The CASS has the following features:

- The service is free to use and it takes seven working days for a switch to complete, considerably shorter than the 18 to 30 working days taken before its introduction. The customer can switch on a date that suits them that they choose and agree with their new bank
- Payment arrangements, including direct debits and standing orders, will be transferred automatically and all payments will be made from the new account the day the switch process completes
- Payments to the old account after the switch completes are redirected automatically to the new account. This redirection service runs for 13 months

[248] Meeting with Aldermore, August 2013.

after the switch completes so as to capture regular, monthly and annual payments

- The old account is closed and the closing balance is transferred automatically to the new account
- Use of the CASS will not affect credit ratings, no matter how many switches take place
- Multiple switches can be made during the 13-month redirection period and the service will update records to transfer payments to the newest account
- The switching process is managed by the new bank so, if a customer has any questions or concerns, they have a single point of contact. This means that if a customer wishes to switch a current account to a new bank there is no need to talk to the old bank as part of the process.
- The CASS has a guarantee so that if anything goes wrong with the switch, users will receive a refund of any interest paid or lost, as well as refunds of charges on the old or new account as a result of the failure.

8.60 We consider that there is scope for the CASS to go at least some way to addressing certain of the actual and believed costs of switching referred to above. Indeed, it has been successful from an accuracy and operational perspectives, with 99% of switches being completed within the seven working day timescale.[249]

8.61 However, at the current time, we cannot say that the CASS has had a substantial and sustained impact on SME switching behaviour. In particular, the CASS has resulted in a modest overall increase in year-on-year switching volumes for both PCAs and BCAs of 16% in the six-month period to the end of June 2014.[250] As regards SME banking specifically, only 1.8% of switchers using the service over this period were identified as being SMEs or charities.[251] This means that some 7,330 SMEs switched using this service in that six-month period, out of a total of over 3.5 million BCA account holders.

8.62 In addition, and importantly, awareness of the CASS among SMEs of the applicability of the CASS to SMEs appears to be limited according to qualitative research conducted by the Payments Council, and below that of

[249] Source: Payments Council CASS dashboard (1 January – 30 June 2014), published July 2014. This describes the time to switch using CASS metrics, and does not take account of the account-opening process. Most large banks can generally supply Internet banking and debit cards within the seven working day time frame should the customer bring all paperwork required by the bank into the branch in one go. However, there may be delays in receiving all relevant documentation which could increase the overall time taken to switch.
[250] Source: Payments Council CASS dashboard published July 2014.
[251] This figure excludes businesses using PCAs for their business transactions. This represents an increase from the previous six-month period up to March 2014.

personal customers.[252] A recent survey commissioned by one of the UK's largest banks also showed that SME awareness of the CASS is low and only a minority knew that it applied to some businesses.[253] This may reflect the fact that the Payments Council has not undertaken SME-specific advertising because its research suggested that the best way of reaching SMEs would be through mainstream advertising.

8.63 It is possible that the CASS will, over time, have a greater impact than the above evidence suggests. However, its current impact does not allow us to conclude that concerns about barriers to switching have been removed at present, or that we can reasonably conclude that it is foreseeable that they will lessen substantially or cease to exist in the short term.

Conclusions on barriers to switching

8.64 The above analysis indicates that, in addition to low rates of shopping around and low rates of switching, there remain among many SMEs a number of significant barriers to switching (as well as certain believed switching costs) which limit their future likelihood of switching. These barriers reinforce the 'stickiness' of SME customers which we have observed, reducing their ability to drive effective competition between providers.

Competitive constraints – alternative measures to 'switching' data

8.65 We recognise that the evidence presented above regarding levels of switching does not represent the full extent of the competitive constraints faced by BCA and business loan providers. In this section, we explore various reasons why providers may face greater constraints than switching statistics appear to indicate:

- some SMEs may choose to use more than one provider simultaneously (multi-banking)
- some SMEs may switch provider by keeping the old account open (partial switching) and/or they may maintain a dormant or unused account in case they need it in the future
- changing BCA provider at the end of an introductory period

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[252] The Payments Council's quarterly dashboard published in April 2014 indicated that around 60–70% of adults had heard of the CASS.
[253] Survey information provided by one of largest UK banks. In that survey, 28% of SMEs considering switching knew that CASS also applied to some businesses. The proportion was 26% for those not considering switching and 41% for switchers (SMEs that had changed their BCA in the last 5 years – there was a low number of respondents (48) that had switched).

- the relevance of churn, as new SMEs are established and take out BCAs

We consider each of these in turn below, considering whether they materially affect the analysis which we have set out earlier in this chapter.

8.66 We have also noted arguments from various banks that low levels of switching reflect SMEs' wide satisfaction with their bank(s), which, if it were the case, would also indicate that lower switching rates do not meaningfully reflect the outcomes of competition. We consider the issue of SME customer satisfaction in Chapter 9.

Multi-banking

8.67 Various banks have highlighted that many SMEs choose to transact their business with multiple providers. Indeed, survey evidence we have seen suggests that three in ten SMEs use more than one bank. One bank also told us that its SME customers sourced only 58% of their total banking products from it.

8.68 We recognise the relevance of multi-banking to an assessment of competition, in so far as it demonstrates that SMEs are using a variety of different providers for the same banking product, choosing to use whichever of those providers is likely to offer them the best deal at any point in time.

8.69 However, the evidence indicates that multi-banking remains very limited for core banking products such as BCAs and business loans. For example, survey evidence, presented in Chapter 4, shows that around 90% of BCAs, overdrafts and business loans are provided by an SME's main bank.[254] Although larger SMEs appear to be more likely to multi-bank, it continues to be the case that for core products there remains, in the large majority of instances, a tendency for even these SMEs to obtain these products from their main bank.

8.70 This preference for using a single bank for an SME's main banking products is consistent with the evidence we have seen during the market study that SMEs consider single sourcing to have benefits:

- Many SMEs believe that there are benefits in building a long-term relationship with a bank as they may take the view that their main bank is likely to hold sufficient information to enable them to take more favourable lending decisions (as we discuss above)

[254] Charterhouse Business Banking survey, Q3 2013.

- Survey evidence on why SMEs only use one BCA indicates that many SMEs do so, particularly larger SMEs, as it makes financial management easier[255]

8.71 That is not to say that multi-banking is irrelevant. Indeed, we observe significant evidence of some SMEs using more than one bank for certain services, particularly:

- Insurance
- Credit cards
- Asset finance
- Factoring and invoice financing[256]

8.72 Therefore, while multi-banking is relevant in interpreting the switching data, it is important to note that its effect in relation to many banking products is limited. In particular, multi-banking remains limited among the core banking products (including the focal products included in the market study). To the extent that it does constitute a significant factor, this appears to be particularly relevant to larger SMEs which are more prepared to engage in multi-banking, but who only account for a very limited share of the overall SME population.

Partial switching and dormant accounts

8.73 Switching rates may not reflect the SMEs' ability to change BCA without closing their old BCA (referred to as partial switching).

8.74 However, the information which we have used to consider switching rates takes account of partial switching, so that in the BCA market, while partial switching does occur, it seems unlikely to add significantly to the constraint that SMEs can place on providers. For example, Charterhouse found that around 52% of SMEs that reported switching their main bank in the previous year had switched away completely and closed the account. A further 26% had made a partial switch where they had left the old account open and were still dealing with the bank, but no longer using it as their main bank. A further 22% had switched and moved all their business to the new account but had left the old account open (ie left open a dormant account).[257]

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[255] YouGov (2013), 53% of SMEs with above £1 million turnover say that they use only one BCA because it makes financial management easier, compared with 31% for SMEs with turnover below £100,000 and 43% for SMEs with £100,000–£999,999 turnover.
[256] Charterhouse Business Banking Survey, Q3 2013.
[257] Charterhouse year ended Q3 2013.

Changing BCA provider at the end of the free banking period

8.75 The end of the free banking period represents a significant change to the terms that SME customers face, as full transactional charges are applied. Given this, it seems reasonable to expect that SMEs would be more likely to switch around the end of a free banking period, especially if they are particularly price-sensitive.

8.76 Each of the four largest UK banks has provided evidence that shows an increase in account closures[258] around the time of the end of the free banking period. For example, one bank has carried out an analysis of factors associated with customer attrition in 2012 and found that the end of free banking was one of a number of factors that contributed to a higher switching rate among SME customers. It estimated that the switching rate would be 1.8 times higher for these customers once other characteristics were controlled for, while another bank noted that the peak period of account closures occurs in the final month of free banking and in the subsequent month. The increase in account closures and attrition rates occurring at the end of the free banking period therefore appears to represent a short-term 'spike' rather than a permanent shift to higher levels of account closures.

8.77 However, the banks do not have evidence to show whether the increased account closures were due to customers switching to other providers or due to other reasons, such as SMEs ceasing to trade or SMEs which are winding down closing their accounts (on which there may be little or no activity) to avoid incurring further charges.

8.78 While it is difficult to distinguish between the reasons for account closure, it is very likely that much of the increase in account closures is due to an increase in switching by SMEs around the end of the free banking period. This is perhaps not surprising, given the very significant change to their terms, with many potentially paying significant transaction charges for the first time. We note further that the evidence does not indicate that the increase in switching at the end of the free banking period has a prolonged effect, instead lasting only a few months. Finally, the increase in switching is, in any event, included in the overall switching statistics.

[258] The data also shows an increase in attrition rates, and subsequent references to account closures in this section refer also to attrition rates. Account closure data shows the absolute number of accounts closed, while attrition rates represent the number of accounts closed as a percentage of some baseline stock of accounts.

Relevance of 'churn'

8.79 During the market study, various of the banks have made the point to us that, in considering the relevance of switching, we should take account of the high rates of 'churn' in the sector – that is:

(a) providers acquiring and losing a significant volume of new customers each year as new SMEs are established and other SMEs cease trading; and

(b) SMEs switching providers.

8.80 The banks have pointed to high rates of churn in SME banking as indicating that banks need to compete considerably harder than might be suggested by the 4% annual rate of switching, given the need to replace lost customers.

8.81 We acknowledge that churn rates in SME BCAs are considerable. They were between 14 and 24% for the largest banks, based on information provided to us during the market study. There are two elements to this churn, as noted above. The high rate of churn is largely driven by the first of these elements, reflecting the high rate of SME formation and closures,[259] and the low rate of switching.

8.82 It has been put to us that, notwithstanding the low switching rates, the effect of having to acquire significant volumes of customers each year has a substantial impact on competition, by ensuring that banks compete particularly intensely for new customers in order to prevent significant losses in market share.[260] One implication of this may be that it is inappropriate to focus concerns on 'back book' customers that give little consideration to changing provider once they have initially chosen a bank. If competition is intense for all SMEs when they are initially choosing their bank, leading to low pricing for start-ups (and switchers), then SMEs will have benefited from competition at an important stage in their life cycle, even if there is not intense competition for their custom at later stages, largely due to limited switching or multi-banking. Similarly, this argument suggests that while new-to-bank customers may not be very profitable to the bank in the short term, they will be profitable to the bank in the longer term if they remain in business and grow and do not switch away.

8.83 Another implication of this argument is that there is a strong degree of price discrimination between SME customers which are new to a bank (both start-

[259] New businesses account for 10% of the stock of UK businesses each year. Source: ONS Business Demography, 2011, showing business birth rates in the UK, 2004–2011.
[260] This argument has already been set out in Chapter 4.

ups and switchers) and those SME customers which are established customers with that bank. Indeed, we see periods of 'free banking' offered to start-ups and switchers. As described in Chapter 4, the costs of switching banks for SMEs may mean that smaller banks have a stronger incentive to compete for new customers than larger banks do when banks cannot charge lower prices to these new customers than they can set to existing customers. On the other hand, if a bank can set a cheaper BCA tariff for new customers (start-ups and switchers) than it sets for existing customers, and so effectively price discriminate between the two groups, then it can attract new customers without undermining and exploiting the profitability of existing customers. The ability of banks to price discriminate between new and existing customers would imply that banks have similar incentives to charge relatively high prices to existing/back-book customers and lower prices to new customers, whatever their size. This could imply that concentration is not, in itself (or by itself), a source of concern in this market.

8.84 It may be the case that a high rate of churn is relevant to any consideration of switching rates. A focus on switching rates may not reflect how competition works in this market and could underestimate the extent of effective competitive constraints. The high proportion of SMEs exiting the market, in addition to switching, may mean that larger banks cannot rely solely on a 'locked-in' base of existing customers and low switching rates. Rather, they must compete for new customers to replace the customers they lose.

8.85 These arguments have force and are relevant to the competition analysis. However, we have concerns about the intensity of competition for new customers and how this impacts on an assessment of competition for all SMEs, both new customers and banks' existing customers. Price discrimination and the high rate of churn in the market could potentially mean that there is very intense competition for new customers. In turn, this could mean that any potential excessive profits earned by banks from their existing back-book customers are competed away through below-cost price competition for new customers. However, there are reasons why we do not think this is the case. These are:

- First, there are good reasons to doubt that competition for new customers is sufficient to ensure that there is sufficient competition overall in SME banking markets, making it less likely that the benefits of competition for new customers are likely to offset the negative effects of a lack of competition for banks' existing customers. Specifically:

- — There is a strong propensity for start-ups to choose a BCA provider based on their choice of PCA provider, as illustrated in Chapter 4.[261] Therefore, a bank is less likely to capture new-to-market SMEs if it does not hold their existing PCA. This limits the growth potential of stand-alone business bank providers, or of entrant banks lacking a strong presence in PCAs, and consequently restricts competition.

  — Another important factor in influencing an SME's choice of BCA provider is the location of the closest bank branch to the business.[262] Therefore, the need to have a network of local branches could limit the degree to which smaller banks with little or no branch presence may attract new-to-market SMEs (or, indeed, potential switchers). This, in turn, may limit the intensity of competition for these SMEs.

- Second, if competition for new customers is not very intense, then any excess profits that bank might secure on their existing back-book customers are unlikely to be competed away. The offer of free banking to start-ups was prevalent at the time of the CC inquiry. Nevertheless, the CC found that the four largest clearing banks in England and Wales were making excess profits on banking services to SMEs between 1998 and 2000.[263] While we have not undertaken a profitability assessment, as we have explained above, there are factors that likely limit the intensity of competition for start-ups, making it unlikely that all rents on back-book customers are competed away. In addition, many of the features and the structure of the market are very similar to when the CC undertook its market inquiry and found evidence of excessive profits despite free banking offers to start-ups and switchers.

8.86 Introductory free banking periods for new customers may lead to competing away of some of the rents on back-book customers. However, for the reasons set out above, this price discrimination and the level of churn do not appear to affect the overall conclusion that competition is not sufficiently effective in these markets.

Conclusions

8.87 Shopping around, negotiating with an existing provider and switching provider are important ways for customers to act in a manner which drives effective

[261] This point has also been made in Chapter 8.
[262] This issue is considered in detail in Chapter 5.
[263] CC (2002).

competition between providers. The combination of these three responses will give an indication of the negotiating power of an SME.

8.88 Among these, switching provides a direct competitive constraint and is therefore a significant indication of the intensity of competition in a market. The other two responses are more difficult to measure directly. We have therefore used the level of search activity and the use of bespoke terms as potential indicators of how widespread these responses are likely to be.

8.89 The evidence set out in this chapter suggests that, overall, most SMEs engage in relatively limited shopping around, do not negotiate with their bank and do not switch, suggesting that competitive constraints arising from SME customer behaviour are limited. We note, however, that for the larger SMEs, there is evidence of greater engagement with their banking provider, which could ultimately result in them being in a position to exercise a greater constraint on their banks, albeit these SMEs account for a very small proportion of the total SME population.

9. Outcomes for SMEs

Key facts:

- Only 13% of SMEs trust their bank to act in their best interests.
- Only 25% of SMEs consider that their bank supports their business.
- While levels of dissatisfaction are low (10 to 20%), they are much higher than the annual rate of switching (4%).
- Levels of satisfaction are also limited – satisfaction scores are around 60% for BCAs. Satisfaction is lower than for companies in other sectors such as telecommunications and energy. However, larger SMEs tend to be more satisfied with their bank.
- Across the sector as a whole, there is a net promoter score of *minus* 8%, indicating that more SMEs would be unwilling to recommend their bank to a friend than would be willing to do so. Smaller banks, however, tend to have higher net promoter scores.

9.1 In the preceding chapters we have considered various features of the markets for the focal products, highlighting that there are grounds for competition concerns arising from these features, either individually or together.

9.2 In this chapter, we consider outcomes of these markets and what these may indicate about the intensity of competition in the market. In doing so, we will consider evidence on:

- service
- price
- innovation
- satisfaction levels, which we would expect to reflect the above factors

9.3 We then consider briefly the extent to which the intensity of competition may vary for different categories of SMEs.

9.4 There are particular challenges with assessing outcomes in any ‘Phase 1’ market study. Such market studies, by their very nature, do not tend to explore thoroughly and comprehensively all the evidence which may be relevant to an assessment of outcomes. For example, analyses of profitability or of margins would normally require a ‘Phase 2’ analysis. Similarly, in this market study we have been cautious about the conclusions we can draw from an analysis of pricing given limitations on the information available. In addition, it is generally challenging to know which are the appropriate benchmark outcomes for a competitive market against which one can compare current outcomes. However, these are challenges which normally arise in the context of 'Phase 1' market studies. Moreover, it remains important to examine whether available evidence on outcomes is broadly consistent with concerns raised about the effectiveness of competition.

Service

9.5 We have been informed during the market study that SMEs place a particularly high value on the non-price offerings of their banks, particularly the service offered by their banks. Indeed, several of the banks have emphasised that service, rather than pricing considerations, are of the most fundamental importance to their SME customers.

9.6 However, we have also heard concerns about the level of service provided by incumbent banks, expressed by SMEs in focus groups and roundtables, and in discussions with SME representative organisations. Frequently cited concerns included:

- relationship managers (RMs) being unknowledgeable and unavailable
- lengthy processes to receive decisions on loans, and that the RM or local branch was unable to make credit decisions
- fear of seeking an extension of credit, or threatening to switch, as this might lead to existing credit facilities being reviewed and reduced or withdrawn
- there is little differentiation between the largest banks (as expressed in Chapter 8). SMEs often expressed a desire for different banks with different ways of serving customers – Metro Bank and Handelsbanken were cited as good examples

9.7 In this section, we consider the specific evidence we have received on this issue, by reference to the following overall service parameters, which are those most likely to be of significance to SME customers:

- transactional services
- relationship management services

Transactional services

9.8 Transactions can be made by SMEs using a variety of channels, principally branch services and online banking. The evidence we have seen indicates that SMEs are generally satisfied with the quality of transactional services provided by their banks, particularly those provided online, as demonstrated in Table 9.1.

TABLE 9.1 **SME ratings of the transactional services provided by their main bank online and in branch in the previous 12 months**

%

	Online banking service				*Branch counter service*	
	Overall rating of online banking system	*Ease of carrying out transactions*	*Speed with which the bank processes the transactions you initiate*	*Accuracy with which the bank processes the transactions you initiate*	*Overall rating of branch counter service at main bank*	*The accuracy and efficiency with which they carry out your transactions*
Excellent/very good	68	63	66	69	58	62
Good	25	30	28	27	29	30
Fair/poor	7	7	7	4	13	7

Source: Charterhouse, year ending Q1 2013.

Base size 7,343 for online banking and 8,636 for branch counter service.
Note: Proportions may not add up to 100% due to rounding.

9.9 We note that SMEs are asked to rate their bank on a five point scale as ‘excellent’, ‘very good’, ‘good’, ‘fair’ or ‘poor’ by the Charterhouse Survey. Accordingly, we consider that an ‘excellent’ or ‘very good’ rating is likely to indicate that banks are satisfying their SME customers; a ‘fair’ or ‘poor’ rating is likely to indicate that SMEs are dissatisfied with their bank; and a ‘good’ rating, which is equivalent to the midpoint (ie three) on the scale, does not provide a strong indication that banks are satisfying SME’s needs.

Relationship manager services

9.10 Our focus group research confirmed what banks had told us about the importance of RM services,[264] that it is an important element of the banking package for many SMEs.

9.11 During the market study, we have heard various concerns, both through the focus groups and through roundtables, that SMEs perceive that their bank now offers a less personal relationship than it did in the past. In particular, we have been informed that the numbers of relationship managers have reduced, such that many smaller SMEs no longer have a specific relationship manager, but rather have a team or a ‘named point of contact’ within a team of RMs to

[264] BDRC focus group research, slide 40.

satisfy their needs. This concern is consistent with the Large review where it was noted that ‘there is general dissatisfaction with the way that banks serve SME customers, with a perceived depersonalisation of service and disengagement from the needs of customers’.[265]

9.12 We have been told, that while relationship managers can provide important services in helping to fix problems and helping SMEs make the right decisions, they were often perceived as having very little sector or specialist knowledge, did not understand the business of the SME and were overly focused on cross-selling. This is at least partially borne out by survey data (shown in Table 9.2), which demonstrates that, although most SMEs are satisfied with their relationship manager (57% of SMEs rate their RM performance in the previous 12 months as excellent or very good), a significantly greater proportion of SMEs are relatively less satisfied with RM services than with the transactional services. In particular, greater levels of concern were raised about:

- their RM’s understanding of their industry
- suggesting appropriate financial ideas and solutions
- being proactive about contacting them

There also appears to be some variation between banks, with [a smaller bank] in particular outperforming the other banks.

TABLE 9.2 **SME ratings of overall performance of relationship manager in the previous 12 months**

	Total
Excellent/very good	57
Good	23
Fair/Poor	21
Base	7,063

Source: Charterhouse, year ended Q1 2013.

Note: Proportions may not add up to 100% due to rounding.

9.13 Furthermore, while it is inevitable that certain SMEs’ applications for finance will be rejected, we would expect such customers to be served by their relationship managers in an effective manner, with rejected applicants being provided with appropriate support and reasons for the bank’s decision.

[265] Large Review, p15.

However, this does not appear to be the case in many instances, despite bank commitments on this issue.[266] According to the SME Finance Monitor:

- 23% of those who were initially declined an overdraft and 20% of those who were initially declined a loan were not given a reason why
- 40% of overdraft applicants and 53% of loan applicants believed they had not been given enough information to explain the rejection decision
- Only 11% of those declined for a loan were offered an alternative form of lending or suggested any other forms of external finance[267]

9.14 Furthermore, the Large review found significant deficiencies in RBS's RM service:

- RMs were unable to devote sufficient time (and less than before 2008) to customers
- The credit skills of RMs varied and were 'in some instances, still too low'
- There was excessive risk aversion on the part of RMs[268]

In addition, Sir Andrew Large found that RBS's internal processes for lending were considered 'time-consuming', increasing the time taken to approve loans and reducing the productivity of customer-facing staff. Overall, he concluded that this, among other factors, contributed to RBSG not 'succeed[ing] in supporting the SME sector in a way that meets … the expectations of customers'.[269]

9.15 These comments may be considered clear deficiencies in a sector where, as it has been repeatedly submitted to us, effective relationship management is considered important to the service offered to SMEs. We note that RBSG is taking steps to address these areas of concern and that there was a decline in its share of business lending during this period.[270] However, the fact that RBSG remains a market leader in business lending in various parts of the UK and the fact that these concerns persisted is more consistent with our findings

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[266] The banks committed to 'provide clear feedback to SMEs when loan requests are refused and set out what next steps they can take for further advice and support' – see the Business Finance Taskforce Report, October 2010, p32.
[267] SME Finance Monitor.
[268] Large Review, p5.
[269] Large Review, p4.
[270] We note that much of this decline is likely to reflect the run-down of non-core assets and a reduced concentration on real estate lending.

about the relative 'stickiness' of customers than with a market demonstrating strong and effective competition.

9.16 Concerns have also been raised by Dr Lawrence Tomlinson, the former Entrepreneur in Residence at BIS, regarding the treatment of RBS's customers in financial distress, through its Global Restructuring Group.[271] We note the findings of Clifford Chance's review of these concerns, in which it found no evidence to support concerns that, among other points, RBSG systematically and artificially distressed otherwise viable businesses.[272] We draw no conclusions on these issues as the FCA has appointed Promontory Financial Group and Mazars to conduct an independent skilled persons report under section 166 of the Financial Services and Markets Act 2000 into the issues raised by Dr Tomlinson.[273]

Conclusion on service

9.17 We have seen that while SMEs, in general, are satisfied with the transactional services offered by their bank, dissatisfaction levels are higher for relationship management services. Given the importance of effective relationship management services to SMEs, this raises significant questions as to whether competition between banks on this element of service is sufficiently intense given the importance of the service to SMEs.

Pricing

Liquidity management services (BCAs)

9.18 In this section, we consider the prices charged by BCA providers. In doing so, we focus particularly on the extent to which we observe differences between different providers. In particular, we consider whether there are material differences in the pricing of those banks with relatively high and relatively stable market shares compared with smaller banks. Differences may indicate incumbency advantages enjoyed by the larger providers and differences between large and small providers in their incentives to compete on price.

9.19 We recognise, however, that differences in prices between providers can be consistent with effective competition and could reflect the differentiated nature of the products and services on offer. While we acknowledge that differences

[271] Dr Lawrence Tomlinson (2013), Banks' Lending Practices: Treatment of Businesses in distress: A report by Lawrence Tomlinson, Entrepreneur in Residence at the Department for Business. We met with Dr Tomlinson on two occasions during the market study.
[272] Clifford Chance (2014), Independent review of the central allegation made by Dr Lawrence Tomlinson in Banks' Lending Practices: Treatment of businesses in distress.
[273] www.fca.org.uk/news/update-on-independent-review-of-rbs-treatment-of-business-customers-in-financial-difficulty.

may exist in relation to service standards, we observe that, in the case of BCAs, consistent evidence indicates that consumers do not consider there to be significant differentiation between the major providers of BCAs (see Chapter 8).[274] As a result, we consider that BCAs are sufficiently homogeneous that a comparison of pricing between providers is meaningful.

9.20 One approach to analysing BCA prices could be to consider how charges for particular services (eg the fee for lodging a cheque) have changed over time and how they compare between particular providers. However, in general, we consider that this is unlikely to produce a meaningful analysis, given that the price charged to an SME reflects a pattern of different transactions, rather than any individual transaction charge. It is also possible that different providers will focus on pushing down the prices of certain charges at times, while keeping others high, limiting the usefulness of making a comparison of individual charges between providers. We therefore consider that a more meaningful approach is to consider a number of scenarios reflecting various different transaction profiles of different 'typical' SMEs.

9.21 We have also considered the interest rates paid by various providers on BCAs, including the extent of variation between them and what, if anything, we can draw from this in terms of the competition analysis.

9.22 Before presenting our analysis, we summarise the previous OFT and Vickers review findings.

Previous analysis

9.23 The OFT's 2007 review considered three types of 'typical' SMEs, with particular transactional behaviour.[275] It found that there had been notable increases in core charges by HSBC and Barclays in 2005, which the banks indicated had been made in order to restructure their offerings and better reflect underlying costs. The OFT also reported on third party sources which suggested that the largest four banks were more expensive than rival 'challenger banks'.[276]

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[274] This conclusion is consistent with the OFT conclusion in the Lloyds HBOS merger assessment that 'financial products sold to SMEs – although branded – [ ] are relatively homogeneous products' (paragraph 2.80).
[275] This analysis does not consider credit or debit interest, charges related to overdrafts, or services other than money transmission charges.
[276] An assessment by *Business Moneyfacts* in 2005 found that, on average, the largest four banks charged £10 per month more than other banks. A separate survey, by the Manchester Business School, also found smaller banks charging lower prices and indicated that the potential savings from the highest-cost to the lowest-cost provider were between 58 and 145%. OFT (2007), page 68.

9.24 The Vickers review undertook a similar form of analysis, using scenarios with six different types of SME for accounts which allowed branch access.[277] The Vickers review found that, for 2005 to 2010, 'challenger' banks were, on average, 17 to 27% cheaper for five out of the six types of customers reviewed. For the sixth customer type, where most of the transactions were manual, rather than automated, the four biggest banks were 12% cheaper than 'challengers' when cost was averaged out across the five years. The Vickers review commented that 'despite offering better rates on the whole, challengers grew very little over the five years reviewed, indicating that competition may not be working well in this market'.[278]

Analysis

9.25 We have undertaken a similar analysis to those summarised above, considering ten different SME transaction profiles, based on transaction profiles provided by one bank.[279] In doing so, we used published information on bank tariffs from *Business Moneyfacts,* a publication that presents BCA tariffs for around 30 different BCAs. However, some of these BCAs may be offered by banks which are unlikely to have a broad appeal to SMEs, such that we consider it appropriate to exclude them from our analysis.[280]

9.26 We are interested in examining whether there are notable differences in the pricing of particular types of banks. In particular, we wish to examine whether the largest four banks in Great Britain, which have experienced the greatest stability in their market shares over a long period, have pricing on BCA transactions which is higher than the pricing of smaller banks, or pay lower credit interest than smaller banks. This may indicate whether smaller banks compete more intensely. With respect to interest rates charged on overdrafts, many SMEs (particularly larger SMEs) negotiate their terms of the overdraft facility with the bank and as such, no comparison can be made across banks on the basis of the information available at 'Phase 1'. Therefore, we have focused our analysis on credit interest and transaction charges.

9.27 Our analysis of this issue is included at Annex E and is summarised below.

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[277] This analysis is based on published prices and so it does not take account of negotiated prices or different levels of service between banks. In addition to transaction fees, the Vickers analysis considered the cost of interest forgone, but did not include the cost of overdrafts.
[278] Vickers review, paragraph A4.70.
[279] [✂]
[280] We have excluded BCAs offered by the following banks, given their very small share of supply: Bank of China, Bank of Cyprus, Cater Allan Private Bank, Norwich & Peterborough Building Society, Turkish Bank, Unity Trust Bank and Weatherbys Bank Ltd.

Credit interest on BCAs

9.28 We have considered credit interest rates paid on BCAs. We find that the maximum interest rate on credit balances 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 in credit interest.[281]

9.29 While, in absolute terms, given the very low interest rate environment, the difference in interest paid between smaller and larger banks is small, the existence of notable differences seem to us to be significant and are consistent with the largest banks being subject to less competitive pressure than smaller banks.

Charges on BCAs

9.30 We have considered 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. 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 by reference to locality.[282]

9.31 From our analysis, we find that:

- For all scenarios, on average, the smaller banks are less expensive when compared with the largest four banks (across their different brands) in Great Britain.
- The percentage difference between the averages for the larger and smaller banks differs across the scenarios, ranging from 2 to 16% depending on the scenario. There was no scenario in which the largest four banks were less expensive than the smaller banks.

9.32 However, we recognise that there are several significant limitations to this analysis, as we set out in detail in Annex E. Most notably, this analysis relates

[281] The smaller banks are Clydesdale Bank, Bank of Ireland UK, Metro Bank, Santander, The Co-operative Bank, TSB and Yorkshire Bank.
[282] RBS is the only bank which offers a tariff targeted at Scottish customers which differs only slightly from its England and Wales tariff rates.

only to the most common charges for money transmission services, and does not include overdraft charges, which will be particularly relevant to at least some SMEs. Moreover, given the wide diversity of SME transactional profiles, we cannot be confident that these profiles will be fully representative of SME behaviour, given that it is based on transaction profiles at one bank only. Finally, this analysis is dependent on certain assumptions made, particularly the categorisation of the largest and smallest banks.

Conclusion on BCA prices

9.33 While the analysis we present above is consistent with a finding that the largest banks may be subject to less competitive pressure, and therefore able to charge higher prices to SMEs, in the light of the limitations we refer to above, we do not consider it appropriate to draw definitive conclusions on the competition implications of these findings.

Pricing of lending products

9.34 During the market study, we sought data from the largest banks which would allow us to compare loan pricing, particularly interest margins, between different banks and across time. However, following detailed consideration of this issue and detailed discussions with each of the four largest UK banks (including site visits to loan processing locations), we noted that there is significant complexity in the pricing of loans, with the final price taking account of a range of factors.

9.35 In order to establish robust and meaningful data, it would be necessary to control for all of these factors. In particular, with respect to risk, our detailed discussions with the banks demonstrated that there was considerable variation in the way that banks both described and classified risk. This meant that we could not be certain that any apparent differences in the pricing of loans between banks did not represent differences in risk descriptions, rather than indicating differences in the margins secured by the different banks.

9.36 Moreover, the challenges above arose when seeking to compare only banks' 'standard' pricing, as determined by the banks' pricing algorithms. Additionally challenges arise, when the price of lending is negotiated and, therefore, 'bespoke'.[283] As shown in Chapter 8, bespoke pricing is widespread for term loans, and its use significantly varies across banks. In the light of these

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[283] There may not be active or detailed negotiations for the price to be considered 'bespoke', Rather, it is enough that the pricing would not be solely determined by the price list effectively given by the bank's algorithm given the characteristics of the SME.

factors, and taking into account that this is a ‘Phase 1’ investigation, we did not progress further the analysis of loan pricing between different banks.

9.37 However, we have specifically considered the results of analysis conducted by others in recent years, particularly the extent to which average loan pricing has varied over time, and how it compares with the Bank of England base rate and other funding costs. This material can be found at Annex F, but in summary it indicates that:

- There has been a widening of the difference between interest rates charged by banks for term loans and the Bank of England base rate since 2007. This difference, even controlling for the risk profile of SME borrowing, significantly expanded from under 2.5% in each of 2001–04, 2005–07 and 2007–08, to an annual average of 4% or more in each of 2008–09, 2010–11 and 2011–12. This increase is consistent with other evidence which shows that, as the Bank of England base rate was reduced from 2007, the difference between interest rates charged by banks and the base rates increased from around 2% in 2007 to 3% in 2011.
- We would, however, qualify the significance of this with evidence that the financial crisis has had a major impact on the banks’ funding costs. In particular, the overall cost of capital for the banks has also increased due to more demanding regulatory requirements. While from 2011 it appears that banks, on average, are covering their funding costs, operating costs, and risk costs, the analysis we have seen also suggests that interest payments on SME loans, as a stand-alone product, are not generating a sufficient return to meet the expectations of investors, potentially indicating that the profitability of such loans is low.

Conclusion on lending prices

9.38 The evidence indicates that the difference between interest rates charged by banks and the Bank of England base rate on term lending products appear to have increased in recent years. However, banks’ costs of funding also appear to have increased following the financial crisis. Without a full assessment of the profitability of bank lending, which is outside the scope of this ‘Phase 1’ investigation, it is not possible to draw conclusions about the overall changes to term lending profits and what they tell us about the nature and extent of competition.

Innovation

9.39 High levels of innovation may be indicative of vigorous competition in the sector; on the other hand, low levels of innovation may be indicative of a weak competitive environment. In the various submissions we have received from the largest banks, examples were provided of banks seeking to improve their service and relationship management for SME customers. Moreover, we have seen evidence of:

- significant investments being made by banks in mobile and online services, including mobile payment mechanisms, such as Pingit developed by Barclays and Paym
- some innovation in pricing structures, such as the greater use of tariffs with monthly fixed charges, such as the Lloyds monthly price plan and Santander's BCA tariff rather than transaction-based tariffs

9.40 It is challenging to identify an appropriate 'benchmark' against which to measure optimal levels of innovation. Compared with the levels of innovation in relation to PCAs, with the development of several new tariff offers, particularly by smaller banks, the levels and extent of innovation we have observed in the SME banking sector are arguably more limited. Further, we note Mintel's comment that there was 'scant innovation and product development activity among the UK's largest banking groups' in 2013 with the exception of Barclays'.[284] However, we do not draw any firm conclusions at this stage as to whether the current levels of innovation are serving customers well, in the absence of a robust benchmark.

Satisfaction levels

9.41 We have considered SMEs' overall satisfaction levels with their provider of banking services, which we would expect to reflect price, service and innovation. In this section, we consider:

- overall levels of satisfaction and dissatisfaction
- net promoter scores (NPS)
- the extent to which SMEs consider that banks provide value for money, are supportive, and can be trusted
- comparisons with other sectors

9.42 During the market study, we have considered significant volumes of survey information regarding overall levels of satisfaction.

[284] Mintel (2013), p14.

9.43 There are inevitable difficulties in making comparisons between various surveys due to methodological differences, which may partly explain the high variation of the results of the various surveys. We have considered surveys produced by Charterhouse, Quadrangle, the FSB and YouGov surveys, which provide a rating of banks by SMEs. For the year ended Q3 2012, Charterhouse finds that 54% of SMEs rated the overall quality of service as excellent or very good.[285] This figure falls slightly, to 52%, for Q3 2013 (Table 9.6 provides further details).

9.44 Across the other three surveys, between 16% and 48% of SMEs rated their bank highly in 2013.[286]

9.45 On the other hand, 22% of SMEs rated the overall quality of service as fair/poor in the Charterhouse survey rather than excellent, very good or good. In the other three surveys, the proportion of SMEs rating their bank negatively ranged from 8% to 19% depending on the survey in question and the size of SME.[287]

9.46 The surveys above estimate the proportion of SMEs that are satisfied or dissatisfied. Other surveys adopt a different methodology to measure satisfaction, where SMEs are asked to rate their banks and a satisfaction score is calculated. The average satisfaction score for BCAs from the recently conducted Business Banking Insight survey[288] was around 60%. This was based on an extensive sample of 5,000 SMEs.

9.47 Other ratings produced by Extended Performance Satisfaction Index – EPSI (see Figure 9.1), an independent rating organisation, appear to demonstrate that average satisfaction scores for the major banks are very similar to each other, with a rating of around 70 out of 100 for all banks bar Handelsbanken. It is noteworthy that service ratings for Handelsbanken consistently and considerably exceed other banks.

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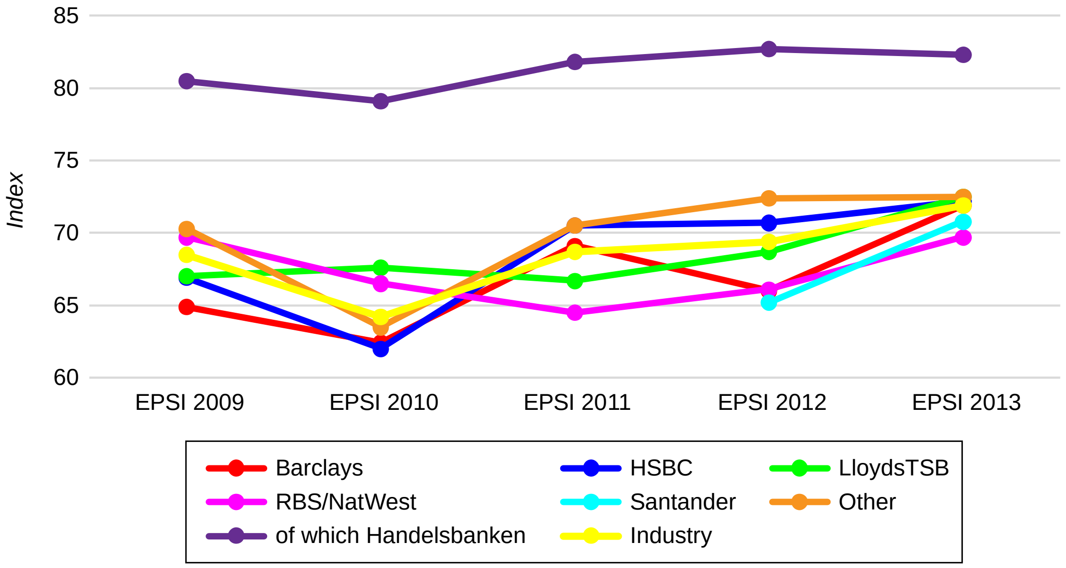
[285] As noted above, the Charterhouse survey asks SMEs to rate their bank on a five-point scale, ranging from 'excellent' to 'poor' with 'good' being equivalent to the midpoint (ie three) on the scale. As such, we consider that a 'good' rating does not provide a strong indication that banks are satisfying SME's needs.
[286] 48% of SMEs gave a rating of 8 or more on their bank's overall service (out of a scale of 10 where 1 is very dissatisfied and 10 is very satisfied) in the Quadrangle (2013)a survey. 16% of respondents rated their bank's service, products and support as very good in the FSB (2013) survey. Between 23% to 32% of SMEs were very satisfied with their bank in the YouGov (2013) survey depending on SME size. YouGov (2013) finds that 29% of micro SMEs (under £100,000 turnover), 27% of small SMEs (£100,000 to £999,999 turnover) and 23% of medium SMEs (over £1 million turnover) and 32% of start-ups (businesses less than a year old) are very satisfied with their main banking provider. (CMA analysis of YouGov (2013) survey).
[287] 19% of SMEs gave a rating of 4 or less out of 10 (where 1 is very dissatisfied and 10 is very satisfied) in the Quadrangle (2013)a survey. 20% of SMEs reported that they rated their bank's service, products and support as very poor or quite poor in the FSB (2013) survey. Between 8% and 10% of SMEs, depending on the size of SMEs, were dissatisfied/very dissatisfied with their bank in the YouGov (2013) survey.
[288] This survey was conducted between March and April 2014.

FIGURE 9.1

EPSI scores for various banks, 2009 to 2013



Source: www.epsi-rating.com/images/stories/epsi_banking_uk_13-press.pdf.

9.48 We have also examined NPS for each of the various banks, as these are measures widely used in banking and other industries to indicate performance in relation to customer satisfaction and loyalty to a particular provider.[289] These scores are based on an SME's likelihood to recommend a particular provider to friends and colleagues. The scoring for this measure is most often based on a 0 to 10 scale. Promoters are those who respond with a score of 9 or 10 and are considered loyal enthusiasts. Detractors are those who respond with a score of 0 to 6. Scores of 7 and 8 are ignored. The NPS is calculated by subtracting the percentage of customers who are detractors from the percentage of customers who are promoters.

9.49 The NPS for the larger and smaller banks in Great Britain is shown in Table 9.3. Overall, the average NPS across banks in Great Britain in 2012/13 was minus 8, which does not indicate strong favourable recommendations of their banks by SME customers. [✂]

[289] We note, however, that NPS levels may not be used by all market participants.

TABLE 9.3 **Net promoter scores across banks in Great Britain**

	All	*Largest four banks*	*Smaller banks*
Net promoter score	–8%	–11%	10%
Base	10,635	9,104	1,531

Source: Charterhouse, year ended Q1 2013.

Notes:
1. Four largest banks are RBSG (NatWest, RBS but excluding Coutts), Lloyds (Lloyds Bank, Halifax, Bank of Scotland), HSBC (excluding First Direct) and Barclays.
2. Smaller banks include Clydesdale, Co-op, Santander and all other banks included in the survey.
3. The percentage shown under 'All' is calculated using a population weight and cannot be derived using the figures for the largest four banks and smaller banks.

9.50 A different source provides the NPS for each of the various banks in Northern Ireland, and is shown in Table 9.4. [✂]

TABLE 9.4 **Net promoter scores across banks in Northern Ireland**

	Bank of Ireland	***First Trust***	***Danske***	***Ulster Bank***	***Other***	***Total***
Net promoter score	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: PwC Northern Ireland Business Banking Tracker Final Report 2012.

9.51 This overall pattern of relatively low levels of satisfaction is consistent with the qualitative information we have received during the market study:[290]

- Various SME representative organisations have highlighted member dissatisfaction about the service and support offered by the large banks. In some instances, they have also highlighted that members perceive newer banks as offering something different.

- Focus group research we have seen has highlighted a 'degree of passive satisfaction' towards providers of SME banking services, rather than active satisfaction.[291]

9.52 Finally, we have also considered evidence on whether SMEs consider that their banks provide value for money, are supportive or can be trusted. Mintel research, published in 2013, indicates that only a relatively small proportion of holders of business bank accounts appear to agree that:

- their bank provides value for money (only 28% of respondents considered that it does so in relation to all banks, falling to 21% among customers of only the largest four banks)

[290] See paragraph 9.6 above.
[291] Quadrangle (2013)b, p19.

- their bank is supportive of their business (only 25% of respondents in relation to all banks thought it was, rising to 31% among customers of only the largest four banks)

- their bank can be trusted to act in the SME's best interests (only 13% agreed with that statement in relation to all banks, falling to 12% among customers of only the largest four UK banks)[292]

Again, such statistics are not a strong indication of intense competition.

Differences in satisfaction levels by size of SME

9.53 Based on survey evidence, it appears that start-up and larger SMEs, principally those with a turnover above £2 million, exhibit greater levels of satisfaction with their main banking provider (see Table 9.5) The pattern of the larger SMEs exhibiting stronger levels of satisfaction is consistent with the Business Banking Insight survey, where the satisfaction score for medium-sized SMEs was 65%, compared with 60% of sole traders and 60% of small businesses.[293]

TABLE 9.5 **Overall satisfaction with service by the SME's main bank (by SME turnover band)**

	Total	*New start-ups*	*Below £100,000*	*£100,000–£500,000*	*£500,001 –£2m*	*£2.1–£25m*
Excellent/very good	52	54	52	50	49	59
Good	26	26	25	29	28	30
Fair/poor	22	19	23	21	22	11
Base	2,913	647	648	538	494	586

Source: Charterhouse release of Q3 2013.

Note: The percentage shown under 'Total' is calculated using a population weight and cannot be derived using the figures by SME size.

Differences in satisfaction levels by market share of banks

9.54 As suggested by the NPS scores above, we have seen evidence that satisfaction levels of SME customers at the smaller banks tend to be higher than those at the largest banks. This is confirmed by survey data from Charterhouse, for which we have figures on satisfaction rates for two different periods – first figures based on one quarter of data (Q3, 2013) and then figures based on one year of data (year ending Q3, 2012), which we present below.

[292] Mintel (2013).
[293] See Table 9.7.

TABLE 9.6 **Overall satisfaction with service by the SME's main bank (by bank size)**

			%
	All banks	*Larger banks (largest four banks)*	*Smaller banks*
*Q3 2013**			
Excellent/very good	52	50	59
Good	26	27	23
Fair/poor	22	22	18
Base	2,913	2,515	398
Year ended Q3 2012†			
Excellent/Very Good	54	52	57
Good	25	26	24
Fair/Poor	21	22	19
Base	9,167	7,789	1,378

Source: *Analysis of Charterhouse release of Q3 2013; †CMA analysis of Charterhouse release of Q2 2011 to Q3 2012.

Notes:
1. Four largest banks are RBSG (NatWest, RBS but excluding Coutts), Lloyds (Lloyds Bank, Halifax, Bank of Scotland), HSBC (excluding First Direct) and Barclays.
2. Smaller banks include Clydesdale, Co-op, Santander and all other banks identified in the survey.
3. The percentage shown under 'All' is calculated using a population weight and cannot be derived using the figures for the largest four banks and smaller banks

9.55 As noted above, the five point scale that Charterhouse use means that 'good' is equivalent to the midpoint on the scale, which we do not consider provides a strong indication that banks are satisfying SME's needs.

9.56 The findings from Charterhouse data are consistent with the Business Banking Insight survey, which allows for a comparison of satisfaction ratings for BCAs and loans between larger banks and smaller banks. The largest difference arises for sole traders, which give smaller banks a higher service rating. More generally, and as noted above, larger businesses tend to be more satisfied than smaller businesses with the banking service they receive, as is reflected in the higher scores that they give their banks.

TABLE 9.7 **Business Banking Insight satisfaction levels for banks in Great Britain**

	Sole traders	Small businesses (1-9 employees)	Medium businesses (10-249 employees)
			% score
	BCA [loans]	*BCA [loans]*	*BCA [loans]*
Average satisfaction	60 [79]	60 [76]	65 [80]
Number of banks used	39 [23]	28 [17]	22 [18]
Average score for four largest banks	58 [78]	59 [75]	64 [79]
Average score for smaller banks*	67 [88]	62 [82]	62 [87]

Source: Business Banking Insight, June 2014.

*The average score for the four largest banking groups and the smaller banks has been weighted by the number of ratings. Some of the sample sizes for the smaller banks are very small, and therefore the results are mainly driven by Santander and Co-op, which have a higher number of ratings than the other smaller banks for each of the SME groups.
Notes:
1. Four largest banks are RBSG (NatWest, RBS but excluding Coutts), Lloyds (Lloyds Bank, Halifax, Bank of Scotland), HSBC (excluding First Direct) and Barclays.
2. For the sole traders, the smaller banks are: Co-op, Handelsbanken, Metro Bank, Santander, TSB and Yorkshire Bank. For small businesses and medium businesses, the smaller banks are: Co-op, Handelsbanken, Santander, TSB and Yorkshire Bank. The difference in which small banks have been included reflects the fact that there were no ratings by small or medium businesses for Metro Bank.
3. Loan satisfaction scores are based on low sample sizes for sole traders (32), small business (9) and medium business (11).

9.57 A similar picture emerges in Northern Ireland, where the BBI website shows sole trader BCA scores for the four largest banks in Northern Ireland as follows: Danske Bank 70%; Bank of Ireland 60%; Ulster Bank 56%; and First Trust 41%. This compares with a score of 77% for Santander.

9.58 However, despite relatively low customer satisfaction scores, we note that the banks with the highest market shares have barely lost market share over time. This is not what might be expected in a competitive market and supports our findings about the ‘stickiness’ of customers, set out in Chapter 8.

Comparisons with other sectors

9.59 Although caution must be used when attempting to make comparisons in satisfaction levels between different sectors, we have considered this to inform our analysis.

9.60 We observe, as shown in Table 9.8, that satisfaction levels in SME banking appear to be below those shown by business customers of various telecommunications services and energy providers. While these industries, and the services provided, are clearly very different from banking, they are similar in that they represent basic, and usually necessary, services for SMEs.

9.61 We observe some 80-90% of business customers of telecommunications and energy services are either very satisfied or satisfied, compared to levels that range from 49% to 78% in SME banking. Levels of dissatisfaction in these industries are around 3% to 10%, which are somewhat lower than those seen for SME banking which range from 8% to 20%.

9.62 It should be noted, however, that Table 9.8 presents satisfaction ratings for SME banking in two ways – first on a conservative basis and second on an alternative basis. The 78% maximum in the conservative range of very satisfied/satisfied SME banking customers comes from Charterhouse. Unlike in Tables 9.1, 9.2 and 9.6 above, 'good' has been treated under the conservative approach as satisfied. Similarly, for the Quadrangle survey, we treated 6–10 out of 10 as very satisfied/satisfied and 1–4 out of 10 as dissatisfied/very dissatisfied.

9.63 However, Quadrangle typically treat a score of 8–10 as being satisfied and 1–4 as being dissatisfied.[294] If we were to treat 'good' as neutral in the Charterhouse Survey (as we have done above given it represents a midpoint score), and treat 8–10 as satisfied and 1–4 as dissatisfied in the Quadrangle survey, the ranges of satisfied/dissatisfied SME banking customers would change. 47–72% of SME banking customers would be very satisfied or satisfied (compared to 80–90% of telecoms and energy business customers). 8–22% of SME banking customers would be dissatisfied/very dissatisfied compared to 3–10% of telecommunications and energy business customers.

9.64 Finally, we note that using these alternative categorisations, in each of the Charterhouse, Quadrangle and FSB surveys, around 50% of SMEs rate their banks as very satisfied/satisfied. On the other hand, around 70% of SMEs surveyed by YouGov rated their banks as very satisfied/satisfied.

[294] See Quadrangle (2013)a, p16.

TABLE 9.8 **Satisfaction levels in telecommunications, energy and SME banking**

%

	Very satisfied/ satisfied	*Neutral*	*Very dissatisfied/ dissatisfied*
Mobile (2010)	91	4	5
Landline (2010)	85	7	7
Internet (2010)	83	7	10
Energy (2013) – micro (0–9 employees)	79	12	6
Energy (2013) – small (10–49 employees)	81	14	4
Energy (2013) – medium (50–249 employees)	84	12	3
Conservative Range in proportions across SME Banking surveys (2013) (minimum and maximum)	49–78	12–30	8–20
Alternative Range in proportions across SME Banking surveys (2013) (minimum and maximum)	47–72	19–34	8–22

Source: Mobile, landline and internet scores from *The Business Consumer Experience, Ofcom, Dec 2010.* Energy figures from *Element Energy, Quantitative research into Non-Domestic Consumer Engagement in, and Experience of, the Energy Market, 2013.*

Notes:
1. Figures may not add up to 100% due to rounding or because of a small number of don't know responses.
2. SME banking surveys used are Charterhouse Q3 2013, Quadrangle, FSB Voice of Small Business survey and YouGov.
3. All surveys apart from Quadrangle and Charterhouse used a five-point scale with two categories that could be interpreted as denoting a positive rating and two categories that denote a negative rating and one neutral response, eg very satisfied, quite satisfied, neutral, quite dissatisfied and very dissatisfied. A ten-point scale was used in the Quadrangle survey. The Charterhouse survey uses a five-point scale (excellent, very good, good, fair, poor).
4. To calculate the conservative range, when using the Quadrangle survey results, response categories have been classified as satisfied (6–10 out of 10), neutral (5 out of 10) and dissatisfied (1–4 out of 10). When using the Charterhouse survey results, response categories have been classified as satisfied (excellent, very good and good), neutral (fair) and dissatisfied (poor).
5. To calculate the alternative range when using the Quadrangle survey results response categories have been classified as satisfied (8–10 out of 10), neutral (5–7 out of 10) and dissatisfied (1–4 out of 10). These are the categorisations that Quadrangle use in its report (see Quadrangle report on BCA Transparency in the SME Market October 2013 page 16). When using the Charterhouse survey results, response categories have been classified as satisfied (excellent, very good), neutral (good) and dissatisfied (fair, poor).
6. The range in proportions across SME banking surveys shows the minimum and maximum proportion across the four surveys and may not add up to 100%.

9.65 We observe that satisfaction rates are broadly lower for SME banking than in the Telecommunications and Energy sectors, under both a conservative and alternative approach, the latter of which is arguably a more appropriate approach.

Conclusions on satisfaction

9.66 We have considered a number of different types of evidence when summarising the degree of satisfaction or dissatisfaction which SMEs have in relation to their SME banking provider. At times, the evidence is mixed. However, overall we believe that the evidence indicates that banks are underperforming in satisfying SME customers. While the majority of SMEs indicate that they are satisfied, the proportion of satisfied customers is lower for SME banking overall than it is for other industries. A negative NPS for SME banking suggests that SME customers are often unimpressed by the services they receive at the prices they pay.

9.67 Linking back to the analysis in preceding chapters, we note that those providers which demonstrate the higher levels of customer satisfaction do not appear to be making significant market share gains. Moreover, we note that whereas around 10% of SME customers rated the overall quality of service in the last year as 'poor', only 4% changed their main bank.[295] These are not what we might expect in a more competitive market, with customers actively driving changes in provider behaviour to address concerns about satisfaction levels.

9.68 As we set out above, we continue to have considerable concerns about the effectiveness of competition in this sector generally. However, consistent with our appreciation of the wide diversity of the SME population, we also recognise that the intensity of competition between banks may vary across the following customer groups:

- start-ups and switchers
- smaller established customers
- larger established customers

9.69 We discuss each of these customer groups in turn below.

Competition for start-ups and switchers

9.70 Banks have a stronger incentive to compete for start-up customers in the hope that they will grow into larger, successful businesses that may be more profitable to serve. This is reflected in the offer by the major banks of free transaction banking to such customers for a limited period of time. Despite this dynamic, the strong relationship which we observe between PCAs and BCAs implies that competition for these start-ups is less intense than it might otherwise be.

Competition for small back-book customers

9.71 Established SMEs with a turnover of below £1 million account for the large majority of SMEs. We would expect that these SMEs are unlikely to be individually profitable, based on the low transaction revenues we have seen, although they are an important and valuable source of deposits to the banks.

9.72 They tend to be served by the major banks and use other providers infrequently. This may limit their ability to use these other providers as credible alternatives to threaten to switch to in any negotiation with their current

[295] Charterhouse data for the quarter Q3 2013.

provider. Competition among the major banks is therefore more likely to be particularly important for these SMEs.

9.73 Moreover, this group exhibits very low rates of shopping around, negotiation, switching and multi-banking, which is likely to reduce the pressure that the banks face to offer better terms.

Competition for large established customers

9.74 Established SMEs with a turnover of over £1 million have more complex needs and are more likely to be borrowing from their bank and be on bespoke terms. Revenues are larger for larger SMEs and they are more likely to purchase other financial products, generally generating greater profits for their bank. The niche providers are therefore more likely to serve these larger customers and large banks are more likely to negotiate with them as they are more valuable. Many large customers may therefore have credible outside options, affording them greater buyer power, demonstrated through the relatively high proportion of these customers on bespoke terms. On this basis, competition for this group of SMEs is likely to be more intense than for smaller back-book customers, reflected in the higher levels of satisfaction we observe for larger SMEs.

9.75 However, certain larger SMEs may also be more 'locked in' to their current provider than smaller SMEs, given that it may be more complex for them to switch, given their greater demand for lending. This may limit the intensity of competition for these customers.

Conclusions on outcomes

9.76 Based on the evidence presented in the preceding chapter, we note that:

- For BCA and loan pricing, the complexity of pricing structures means that definitive conclusions cannot be drawn on this issue at this stage.

- For service and satisfaction, although the evidence indicates that many SMEs are satisfied with the service they receive from their bank, this satisfaction is often passive and is low in relative terms. In addition, overall satisfaction tends to be slightly higher for the smaller banks than for the largest four banks. We also note that greater concerns appear to arise in relation to relationship management services, an area which has been emphasised to us as of particular importance to many SMEs.

9.77 These outcomes do not in themselves demonstrate that the market is functioning poorly, but they are consistent with findings throughout this report which suggest that competition is not sufficiently effective to drive the best possible outcomes for SMEs.

10. Competition assessment

Individual features

10.1 In the preceding chapters, we have considered various features of the SME banking sector. In particular, we have concluded that these markets exhibit the following significant characteristics:

- They are concentrated, with concentration levels persisting over an extended period of time
- Barriers to entry and expansion, although reduced, continue to be present and significant in the markets
- There are low rates of switching, negotiation and shopping around (in spite of the availability of easier switching), with evidence that a clear majority of SMEs consider alternatives to be better or only marginally better
- Transparency and comparability are limited

10.2 In our assessment these market characteristics are consistent with those where competition is prevented, restricted or distorted.

The interaction between these features

10.3 In addition to considering these features individually, our analysis is that the features above are closely interrelated and mutually reinforce one another, resulting in competition being more limited than it would otherwise be. In particular, SME inertia weakens competitive constraints by reducing provider incentives to compete. It also creates significant barriers for other providers to enter the sector, by significantly reducing the number of profitable customers available, making it difficult for newer or smaller providers to grow and develop their business. Customers' belief that there is limited differentiation between providers, which may result from the relatively limited available choice of providers, results in SME inertia. This in turn means that there is no counter-vailing pressure on providers to improve offers to SMEs and differentiate themselves from the competition. To address these concerns, improvements may therefore be necessary to market structure or SME behaviour, or both.

10.4 This dynamic is illustrated below.

10.5 As we have seen in the preceding chapters, a consequence is that the banks with the highest customer satisfaction scores are not winning significant market share, while the banks with the lowest satisfaction rates are barely losing market share – which are not the outcomes one would expect in a well-functioning, competitive market.

11. The SME banking behavioural undertakings

Introduction

11.1 Alongside the market study, the CMA has also undertaken an initial, own-initiative assessment of the behavioural undertakings given by a number of clearing banks in 2002 in relation to SME banking services.[296] The purpose of this assessment is to consider whether, in the light of developments since the undertakings were given, the undertakings, or certain aspects of them, should be reviewed.[297] This section also gives details of the CMA's ongoing assessment of the relevant banks' compliance with the undertakings.

11.2 Consistent with the applicable legal regime, this assessment and its conclusions represent the findings of the CMA, rather than a joint product of the CMA and FCA.[298]

11.3 The relevant background to the CC inquiry, upon which the undertakings are based, and a summary of the undertakings can be found in Chapter 2.

Review of the undertakings

11.4 The CMA has a statutory duty to keep undertakings under review and to consider from time to time whether, by reason of any change of circumstances, any undertaking is no longer appropriate and whether either one or more of the relevant parties can be released from the undertaking or whether the undertaking needs to be varied, or superseded by a new undertaking. As part of its consideration of whether to conduct a review, the CMA initially assesses whether there is a realistic prospect of the review finding that there has been a change of circumstances since the undertakings were first given.[299]

[296] CC (2002).
[297] See Chapter 3 of the CMA variation guidance (CMA11). This position differs slightly from the previous position set out in Chapter 4 of the OFT's scoping paper on SME banking to reflect the abolition of the OFT and the creation of the CMA. However, substantively the overall two-stage process with respect to the undertakings remains substantively the same.
[298] This reflects the fact that the power to conduct reviews of monopoly undertakings, such as the SME banking undertakings, are for the CMA alone.
[299] CMA11, paragraph 3.10.

CMA assessment

Structure of the undertakings

11.5 There are four main elements of the undertakings that are relevant to the current assessment because they are potentially suitable for variation or termination:

- **Transparency Undertakings (Clause 21 to 24 of 'Behavioural Undertakings – Others')**: These undertakings placed an obligation on the banks to compile and provide a range of price information on their services to SME customers, in a form acceptable to the CMA, and to publish this information. These undertakings also placed certain obligations on the banks in relation to notifying and explaining charges levied on unauthorised overdrafts.

- **Switching Undertakings (as detailed in the entire 'Behavioural Undertakings – Switching' and Clauses 5 to 13 of the 'Behavioural Undertakings – Others')**: These undertakings placed an obligation on the banks, following the production of various reports on the switching process, to agree upon reasonable and proportionate timescales for effecting a switch of an SME's banking services while also restricting banks from levying certain charges connected to switching. Having established these timescales, banks were obligated to meet them and to report on their performance in meeting these timescales.

- **Bundling Undertakings (Clauses 17 to 20 of 'Behavioural Undertakings – Others')**: These undertakings restricted the banks from requiring (directly or indirectly) an SME customer to open or maintain a BCA with that bank as a condition for the granting of a loan or business deposit account. These undertakings did not, however, restrict the ability to offer 'integrated' products featuring both a BCA and a loan and/or business deposit account provided that these products were also available separately or for the banks to provide incentives to an SME to agree to open a BCA at the same time as that SME is granted a business loan or opens a business deposit account.

- **Facilitating the provision of portable credit histories to SMEs (Clauses 15 and 16 of the Behavioural Undertakings – Others):** These undertakings require the banks, upon a request by an SME customer, to provide an up-to-date credit history to any specified alternative banking provider, such that that the alternative provider has sufficient information in relation to the SME to make an informed lending decision.

Change of circumstances

11.6 In relation to each of these areas, the CMA has considered whether there is a realistic prospect that there has been a change of circumstances such that a review of the undertakings is warranted. In doing so, we have drawn on the analysis set out in relation to the market study, rather than repeating it in this chapter. We set out our findings in relation to each of the above categories in the undertakings below, before discussing compliance with the undertakings:

- In relation to **transparency**, while the CMA accepts the submissions from various banks that the undertakings have played a role in improving transparency of prices, as we have set out in Chapter 7, our current analysis on this issue finds that concerns about transparency and comparability of prices remain. In this light we consider that there is not a realistic prospect of there being a relevant change of circumstances. We consider that these undertakings should therefore continue in place to continue to provide a minimum, albeit incomplete, standard with respect to the transparency of prices.[300]

- In relation to **switching**, the CMA's analysis set out in Chapter 8 is that concerns with respect to the switching of BCAs remain. However, as we also set out in that chapter there has been an important improvement in the switching process following the introduction of the CASS, which applies to SMEs with a turnover of below €2 million (or with fewer than ten employees) (affected SMEs). In our view, there is a realistic prospect for believing that the CASS substantially supersedes the obligations with respect to the timing of the switching process and measurement of performance included in the Switching Undertakings for affected SMEs. Moreover, in our assessment, the CASS has certain advantages over the switching undertakings:

  — It provides greater clarity for affected SMEs regarding the overall timescales involved in switching BCAs, with a clear seven-day guaranteed switch. This contrasts with the more complex timetables included in the Switching Undertakings for each individual aspect of the switch.

  — It includes a 13-month redirection period for payments into the SME's old account, providing additional guarantees for switchers that they will

[300] With respect to the transparency of overdraft charges, which are also a focus of these undertakings, this issue has not been raised with us during the course of the market study.

receive all relevant payments, without the risk of them being diverted to an old account.

— It has a broader coverage, covering 17 financial institutions representing 33 bank and building society brands. This is in contrast to the nine (now eight as a result of the Lloyds/HBOS merger) banks subject to the Switching Undertakings.

— The CASS also has a particular marketing budget to promote the service, albeit one principally focused on PCA customers. Moreover, it publishes a quarterly dashboard, setting out the level of switching activity.

Although the CMA has reasonable grounds to believe that the CASS has not fully addressed the concerns raised in relation to switching BCAs, it does consider that there is a reasonable prospect that it represents a change of circumstances, which may mean that the undertakings, in so far as they relate to SMEs with a turnover of below €2 million, are no longer appropriate and should now be reviewed. Moreover, the CMA recognises that the maintenance of two different switching frameworks, the CASS and the framework included in the Switching Undertakings, is likely to be undesirable for the banks themselves and, to the extent that it leads to any confusion, for SMEs.[301] With respect to SMEs with a turnover of above €2 million, in the absence of coverage by the CASS, the CMA has not identified a realistic prospect of a change of circumstances being found and, therefore, should not be reviewed. Moreover, the CMA has not identified any change of circumstances with respect to those aspects of the undertakings which relate to the imposition of switching charges or wider issues with respect to switching.[302]

- In relation to bundling, the CMA has identified specific concerns with respect to compliance with the aspects of the undertakings which relate to the bundling of BCAs and loans and deposit accounts. Moreover, we note the continued close linkages between BCAs, loans and deposit accounts, with BCAs continuing to act as a ‘gateway’ for those products, such that wider concerns about limited choice on the part of consumers do not seem to have been addressed. The CMA has therefore not identified a realistic prospect of a change of circumstances in relation to this aspect of the

[301] One bank submitted that the switching undertakings restrict the use of the full CASS as SMEs have to rely on the new and old bank complying with the existing undertakings, rather than the new bank being responsible for the switching process.
[302] More generally, clause 10 of the undertakings now seems to have been superseded in the light of both the production of the relevant report and the work completed by the banks in establishing the CASS. These factors would give rise to a reasonable prospect of a change of circumstances in relation to that clause of the undertakings.

Undertakings which would mean that these undertakings could be varied, superseded or removed.

- In relation to portable credit histories, during the review a number of banks have indicated that requests for portable credit histories have been very low, with one reporting that it had received only 20 such requests over the last 12 years and another reporting that it had received no more than a 'handful' of requests. The CMA notes the Government's proposals to legislate to mandate the sharing of credit information, particularly BCA information which forms an important part of the portable credit history, and which we have been told is the most relevant information for a bank when it is making lending decisions. We consider that the Government's firm proposal is highly likely to create a realistic prospect of there being a change of circumstances in the short term, albeit before taking a final view on this, it will be necessary to wait until these proposals have actually been implemented; until that is the case, these legislative changes are only potential changes of circumstances.

Compliance with the undertakings

11.7 The CMA has a statutory duty to keep undertakings of this type under review. During the course of this review the CMA has identified specific concerns about compliance by certain banks with their obligations in relation to the bundling aspects of the undertakings.

11.8 To investigate these concerns the OFT obtained further detailed information from each of the banks regarding their practices and procedures in relation to compliance. After considering this evidence, and to obtain a greater level of reassurance from the banks about levels of compliance, the OFT reached an agreement with each of the banks that:

- Each bank agreed that its internal audit function, which is independent of the bank's business banking divisions, would conduct an annual review of compliance. The first report was made by 11 July 2014.

- Each bank has agreed to provide a written annual reminder to all relevant staff to ensure that they are aware of the bundling undertakings and the seriousness with which they are treated by the bank. The first of these was provided to staff by the end of April 2014.

11.9 The CMA has recently received the various internal audit reports from each of the banks and is carefully considering these. Initial indications are that there are some good examples of compliance at certain banks, but also potential grounds for compliance concerns at others. The CMA intends to make a further announcement on this issue once it has completed its review of these reports, setting out what, if any, further actions it considers need to be taken in relation to any particular bank or banks, including the possibility of enforcement action to ensure compliance with the undertakings.

Conclusions

11.10 In the light of the above, the CMA believes that there is a realistic prospect of there being a change of circumstances such that the undertakings should be subject to a review to assess whether they should be varied.

11.11 The CMA will now consider whether such a review is an administrative priority for the CMA, by reference to its prioritisation principles. We invite views from parties on whether, in their view, a review should be a priority for the CMA and any comments that they may have on our conclusions regarding the change of circumstances. Such comments should be received by **5.00pm on 17 September 2014**:

Retail Banking Team
Competition and Markets Authority
Victoria House
37 Southampton Row
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Email: retailbanking@cma.gsi.gov.uk

The CMA will take a prioritisation decision on this issue following consideration of parties' responses.[303]

11.12 In the meantime, the CMA, consistent with its statutory obligations, will continue to keep these undertakings under review.

[303] The CMA will not necessarily consult on its view on whether there is a realistic prospect of a change of circumstances in each instance where it will conduct a review. However, it is doing so in the specific circumstances of this case given the consultation taking place on the question of an MIR which includes issues in relation to switching.