

RETAIL BANKING MARKET INVESTIGATION

Statement of issues

Introduction

1. On 6 November 2014, the Competition and Markets Authority (CMA) Board, in exercise of its powers under section 131 of the Enterprise Act 2002 (the Act), made a reference for a market investigation into the supply of retail banking services¹ to personal current account (PCA) customers and to small and medium-sized enterprises (SMEs) in the UK.
2. The CMA, acting through a group of independent members constituted from its panel, is required to decide whether any feature or combination of features of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.² If the CMA decides that there is such a prevention, restriction or distortion of competition, it will have found an ‘adverse effect on competition’ (AEC).³
3. This issues statement is based on the evidence we have reviewed to date⁴ with respect to the supply of retail banking services in the UK and sets out our initial hypotheses of what features – if any – of the supply of retail banking services might give rise to an AEC(s), and what might be the adverse outcomes of any such AEC(s). This will provide a framework for our investigation. In drawing up these points, we have been mindful of the complexity and size of the markets involved and the time we have available to carry out our investigation. The points in this document should be seen only as potential

¹ As defined in the terms of reference. All references in this issues statement to retail banking services should be read accordingly. In relation to personal customers, the term retail banking services is limited to PCAs including overdrafts and does not include other banking products to personal customers such as savings accounts or personal loans. In relation to SMEs, retail banking services cover a broader range of banking products including not only business current accounts and overdrafts but also general purpose loans and deposit accounts.

² See [section 134\(1\)](#) of the Act.

³ As defined in [section 134\(2\)](#) of the Act.

⁴ The principal evidence we have drawn upon is: [CMA decision to make a market investigation reference, 6 November 2014](#); [CMA provisional decision on a market investigation reference, 18 July 2014](#); [CMA and Financial Conduct Authority \(FCA\) market study in respect of banking services to small and medium sized enterprises \(the ‘SME Market Study’\), 18 July 2014](#); [CMA market study update into personal current accounts \(‘the PCA Market Study’\), 18 July 2014](#) (together ‘the Market Studies’); [the Competition Commission’s market investigation into small and medium enterprise banking services 2002](#); and previous other reviews and reports in the sector including those listed in footnote 9 below.

topics for investigation rather than the CMA's views, let alone its findings or conclusions.

4. We are publishing this statement now to assist those submitting evidence to focus on the issues we envisage being relevant to this investigation. We invite parties to tell us, with reasons, if they believe either that (a) the issues we have identified should not be within the scope of our investigation or are mischaracterised, or (b) there are further issues we have either not identified, or which we have indicated we are not minded to pursue but which we should consider. We ask parties to support their views with relevant evidence (including original documentation and analysis).
5. We plan to hold hearings with a number of interested parties in due course. As our thinking develops, we expect to issue further documents prior to the publication of provisional findings. If we were to find provisionally that there was an AEC, we would also consult on possible remedies. Our administrative timetable has been published on the investigation [webpage](#).
6. To submit evidence, please email retailbanking@cma.gsi.gov.uk or write to:

Project Manager
Retail banking market investigation
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

by **5pm on 3 December 2014**.

7. The remainder of the document is structured as follows:
 - (a) We set out the background to this investigation, explain some of the guiding principles that will inform our approach and set out our understanding of the key characteristics of the provision of retail banking services in the UK.
 - (b) We have identified three groups of high-level hypothesis that may explain how certain market characteristics or combinations of characteristics may be adversely affecting competition and leading to possible adverse outcomes.

Background

8. The two separate market studies⁵ leading to this investigation focused on the supply of personal current accounts (PCAs), and on the supply of banking services to SMEs (together ‘the Market Studies’). The CMA found that there were reasonable grounds for suspecting that there are features, or combinations of features, of the markets for the provision of PCAs and SME banking services that prevent, restrict or distort competition in the UK. The CMA decided that both PCAs and the supply of banking services to SMEs should be incorporated into a single market investigation into the supply of retail banking services.
9. In addition, the CMA also decided to review the undertakings that were put in place following the 2002 Competition Commission investigation into SME banking⁶ (‘the 2002 Undertakings’). Whilst the 2002 Undertakings review is separate from the market investigation, given that there is likely to be significant commonality of analysis carried out during the course of the market investigation and the review of the 2002 Undertakings, we propose to run the two projects concurrently, with the same group of members. We will also wherever possible combine our information requests in respect of each of the market investigation and the review of the 2002 Undertakings, and our consultation processes on each, to minimise burdens on parties common to both. The administrative timetable for the review of the 2002 Undertakings is [here](#).
10. Under the terms of reference, PCA services comprise the provision of an account marketed to individuals rather than businesses, offering facilities to hold deposits, to receive and make payments by cheque and/or debit card, to use automated teller machine (ATM) facilities and to make regular payments by direct debit and/or standing order (‘current accounts’). The majority of PCAs also offer overdraft facilities, whether arranged or unarranged, which enable account holders to withdraw cash beyond the amount held in the account up to a specified amount. However, as set out in the terms of reference, PCA services do not include for the purposes of this investigation:
 - (a) an account in which money is held on deposit in a currency other than the official currency of the UK; or

⁵ The PCA Market Study and the SME Market Study. See footnote 4.

⁶ Nine banks originally provided these [undertakings](#) in 2002. These were: AIB Group (UK) plc (known as First Trust Bank); Bank of Ireland; Barclays Bank plc (Barclays); Clydesdale Bank PLC; HBOS plc (now part of Lloyds Banking Group (LBG)); HSBC Bank plc (HSBC); Lloyds TSB Bank plc (now part of LBG); Northern Bank Limited (now known as Danske Bank); and The Royal Bank of Scotland Group plc (which also includes Ulster Bank Ltd in Northern Ireland) (RBSG). The nine banks became eight following the acquisition of HBOS plc by LBG in 2009.

- (b) a current account mortgage, ie a single account comprising both a PCA and a mortgage, which is regulated and marketed principally as a mortgage.⁷
11. The provision of retail banking services to SMEs, as defined in the terms of reference, includes, but is not limited to, the provision of general purpose business loans, deposit accounts and liquidity management services, including business current accounts (BCAs) and overdrafts. However, for the purposes of this investigation such services exclude other non-lending products such as insurance products, merchant acquiring, hedging services and foreign exchange services.
 12. The terms of reference define an SME as a business that has annual sales revenues (excluding VAT and other turnover-related taxes) not exceeding £25 million. However, we recognise that there are significant differences between SMEs which affect their retail banking needs. For example, larger SMEs generally require more sophisticated services with a wide relationship with their bank and may have better negotiating positions. Start-ups, on the other hand, may be establishing a business relationship for the first time with their bank and will generally have simpler transaction-based needs. We will consider whether such differences between SMEs are material to our assessment of competition in the sector. We will similarly reflect where appropriate customer segmentation in relation to personal current account holders.

Our approach

13. We will define the economic market(s) and consider whether there is any feature, or combination of features, in the relevant market(s) that results in an AEC(s). If we determine that such features exist, we will decide whether action should be taken, whether by the CMA or others, to remedy, mitigate or prevent the AEC.
14. We will focus in our investigation on the detrimental effects on customers of retail banking services that might result from any AEC(s) we identify, considering both short- and long-term impacts. Such impacts could take the form of higher prices, reduced service quality, choice of provider and/or products, less innovation, and/or any combination of these impacts. They will

⁷ Where products marketed as 'offset accounts' comprise two separate accounts, a mortgage and a PCA with credit interest on the PCA being credited to the mortgage account, the mortgage account falls outside the terms of reference and the PCA falls within, even though the two products are linked for the purposes of interest calculations.

inform our assessment (taking into account any relevant customer benefits⁸) of both the net (or incremental) effect of any AECs we identify and, if relevant, of the need for remedies. We set out below, in paragraphs 24 to 50, our current hypotheses of features that may be preventing or restricting competition in the provision of retail banking services in the UK. We also set out below, in paragraphs 18 to 20, our understanding of the key characteristics of the provision of retail banking services that will help develop our thinking.

15. The sector has been subject to several previous in-depth reviews⁹ and, whilst our findings will reflect the current competitive position of the sector, we will be informed by such reviews and will seek to ensure that where appropriate we build on such reviews rather than replicate them. We also wish to ensure that the investigation benefits from the in-depth knowledge of the relevant regulators and their ongoing work in this sector, and that we minimise burdens on the sector by ensuring that we do not unnecessarily duplicate the work of the regulators, in particular with regard to information requests. To achieve this we will liaise with the relevant regulators as appropriate.
16. Finally, in assessing competition and in our consideration both of the 2002 Undertakings and of any possible remedies if relevant, we will be forward thinking, recognising that in the retail banking sector there are a number of changes currently taking place, or which will be taking place within the next few years (see further paragraph 19(j) below on such key changes).
17. We welcome views on how our analysis should take into account the previous reviews of the sector as well as current and future developments in the sector. We also welcome views on how best we can ensure effective cooperation with other regulators and in particular how to minimise the burden on parties of the investigation.

Sector characteristics

18. The markets for the supply of retail banking services are substantial in terms of size and importance, and the functioning of the retail banking sector has a fundamental effect on the welfare of not only individuals and businesses but

⁸ There may be some benefits to customers that only arise as result of the feature adversely affecting competition. For example, whilst regulation may be found to be a barrier to entry, such regulation may ensure that firms meet certain competency or capital adequacy requirements to the benefit of customers. Similarly, customers may benefit from network effects or economies of scale that might otherwise adversely affect competition.

⁹ Including Sir Donald Cruickshank's review of retail banking published in 2000, the Competition Commission's market investigation into the supply of SME banking services in 2002 which resulted in the 2002 Undertakings and The Independent Commission on Banking (the Vickers Report) published in September 2008. In addition, the OFT reviewed the 2002 Undertakings in 2007 and reviewed PCAs in 2013.

also of the UK economy as a whole. There are approximately 80 million PCAs in the UK, 65 million of which are active, and these generated revenues of £8.1 billion.¹⁰ SMEs account for some 60% of private sector employment in the UK and BCAs alone generate well over £2 billion in revenue a year, and SME business loan balances are around £90 billion.¹¹

19. A number of key characteristics will be important in assessing the nature of competition in the sector. Similarly, some of these characteristics will have an impact on our consideration of the relevant product market(s) and their definition (see further paragraphs 21 to 23). We have set out below our current thinking on the sector characteristics which have informed the formulation of our hypotheses set out below. We welcome observations on the importance of these characteristics and whether there are others we should consider.
- (a) The activities of retail banks¹² are highly regulated to maintain the stability of the banking system and to protect consumers. Retail banks are required to obtain authorisation from the appropriate regulatory authority as well as to meet various capital, liquidity and consumer protection requirements.
 - (b) If in credit, PCAs are generally free for customers whereas SMEs will generally pay for their BCAs, by way of a monthly or per transaction fee. In addition, banks can and do differentiate their pricing between customers, in particular between new and existing customers. For example, new customers will often be offered, in the case of SMEs, a period of no or reduced transaction fees.
 - (c) Customers generally prefer to use a single bank to meet the majority of their banking needs. SMEs appear to value an ongoing relationship with their bank, particularly to obtain loans, with most SMEs engaging in relatively little shopping around for BCAs or SME lending products.
 - (d) The Market Studies also identified that customers consider that there is little differentiation between providers and switching rates remain relatively low for both PCA customers and SMEs.

¹⁰ Estimates from PCA Market Study, paragraph 1.1. An active account is defined as an account with at least one customer-initiated transaction in the last three months, ie not dormant.

¹¹ Estimates from SME Market Study, paragraph 1.2.

¹² We use the term 'banks' in this issues statement to cover all providers of retail banking services, including building societies.

- (e) Many products and charging structures can be relatively complex. Customers may find it hard to understand the true costs of products and to compare different products. SMEs may also find it difficult to negotiate terms.
- (f) There are significant linkages between products. The provision of PCAs and BCAs may enable banks to link or cross-sell¹³ other important retail banking services such as credit cards, cash ISAs, deposit and cash savings accounts, personal and business loans and, for SMEs, other forms of finance. For example, more than half of SMEs obtain their BCA from their PCA provider¹⁴ and almost 90% of SMEs take out a loan with their main BCA provider.¹⁵
- (g) Both the SME and PCA banking sectors are relatively concentrated throughout the UK. The Market Studies found that the four largest banks¹⁶ accounted for 85% of BCAs and 77% of PCAs¹⁷ in England and Wales. Scotland and Northern Ireland are more concentrated.¹⁸ In addition, market shares have been relatively stable over a prolonged period. The Market Studies also highlighted that those banks with relatively lower reported satisfaction levels have not significantly lost market share and those with higher reported satisfaction levels have not gained significant market share.
- (h) The four largest banks in particular have extensive local branch networks. Such networks appear to be important for a significant proportion of customers and the banks themselves appear to consider it important to maintain or, in the case of smaller providers, to grow their networks to attract both SME and PCA customers.
- (i) New entrants require access to a number of key inputs such as finance, IT, customer creditworthiness information and payment systems. New entrants and smaller operators may depend on the larger incumbent banks for such inputs.

¹³ We refer to products that enable such linkages and cross-selling between products as 'gateway' products.

¹⁴ See SME Market Study, Chapter 4, paragraph 4.37 et seq.

¹⁵ See SME Market Study, Chapter 4, paragraph 4.39 et seq.

¹⁶ Barclays, HSBC, LBG and RBSG.

¹⁷ SME Market Study, Chapter 4, and PCA Market Study, Chapter 2.

¹⁸ The Market Studies found that in Scotland, RBSG, LBG and Clydesdale Bank accounted for over 80% of main banking relationships with SMEs (SME Market Study Report, paragraph 4.17 et seq). In Northern Ireland, Danske Bank and Ulster Bank (part RBSG) accounted for 63% of liquidity management services to SMEs, with the next two largest providers accounting for a further 27% (SME Market Study, paragraph 4.20 et seq). Similar high levels of concentration were found in relation to business loans. See also PCA Market Study, Chapter 2.

- (j) There have been in recent years and will continue to be a number of developments in the sector including:
- (i) new entry and bank and branch divestments;¹⁹
 - (ii) changes in the regulatory regime for authorising new banks and the introduction of seven-day current account switching services (CASS);
 - (iii) the establishment of a payment systems regulator (PSR) and the development of alternative payment systems such as PayPal;
 - (iv) greater provision of online and mobile banking services; and
 - (v) implementation of the EU Payments Accounts Directive aimed at increasing the information available on products and charges, as well as new legislation to increase the availability of SME creditworthiness information.
20. These sector characteristics and ongoing developments will be important in our assessment of whether an AEC exists, as well as any consideration of remedies. The benchmark against which we will assess an AEC is that of a 'well-functioning' market; that is one that works well for customers. This benchmark is not based on an idealised or theoretical notion of a perfect market, but will reflect a realistic assessment of likely outcomes in the absence of any features giving rise to AECs that we identify.

Market definition

21. The Market Studies focused on PCAs, BCAs²⁰ and SME business loans. We will consider whether these products represent separate markets, or whether the product market should be widened to include any substitute products, for example in the case of SME business loans: invoice finance (factoring and invoice discounting), asset finance (including leasing and hire purchase) and peer-to-peer lending.
22. Previous studies have not identified separate local or regional markets for retail banking services, reflecting that competition was across areas at least as wide as (i) England & Wales; (ii) Scotland; and (iii) Northern Ireland. The Competition Commission's 2002 market investigation identified separate markets in (i) to (iii) for SME liquidity management services and general

¹⁹ Including the divestments by LBG and RBS required under state aid rules.

²⁰ Most PCAs and BCAs include an overdraft facility (which the customer may or may not make use of). Some PCAs and BCAs do not include an overdraft facility, for example basic bank accounts.

purpose SME business loans.²¹ The SME Market Study similarly considered competition for SME liquidity management services and SME business loans separately within each of England & Wales, Scotland and Northern Ireland. For each separate product market, we will consider whether there are separate geographic markets in each of England & Wales, Scotland and Northern Ireland; or whether the geographic market is wider than this, ie Great Britain or the UK.

23. Market definition is a useful tool, but not an end in itself, and identifying the relevant market involves an element of judgement. The boundaries of the market do not determine the outcome of the CMA's competitive assessment of a market in any mechanistic way. Our competitive assessment will take into account any relevant constraints from outside the market, segmentation within it, or other ways in which some constraints are more important than others.²²

Hypotheses for investigation (theories of harm)

24. To provide focus and structure to our assessment of the way that competition is working, we set out below three groups of high-level hypotheses for investigation, our 'theories of harm'. A theory of harm does not imply any pre-judgement of an AEC; it is solely a hypothesis to be tested. Our investigation is at a very early stage, and the purpose of identifying these hypotheses is to present some early thinking on these issues for comment, to help frame our investigation. Whilst our three groups of theories apply across PCAs, BCAs and other SME products, recognising the similar issues raised across these products, our analysis of the evidence and assessment of how competition is working will differentiate as appropriate between the different reference products, as well as between potential geographic markets where applicable.
25. These theories of harm are not necessarily mutually exclusive, indeed some are closely related. Equally, the list may not be comprehensive, in the sense that there might be other issues that we choose to consider in the course of the investigation. As our understanding develops, we may find that some or all of these theories do not hold, and/or identify others.
26. There are many dimensions to the provision of retail banking services and as noted previously they have been in one form or another subject to significant previous competition review. We will take full account of the work done to date and also of the current work of the relevant regulators. We have identified in relation to each theory of harm potential areas of analysis and evidence

²¹ However, it identified a UK-wide market for other SME loans and longer-term business deposits.

²² CC3 Revised, paragraph 133.

gathering. We will look at PCAs and SME banking separately in these analyses (and indeed segmentation within different products, customers and geographical areas as appropriate). Whilst these areas are not exhaustive and we may decide not to pursue certain of them, we would welcome comments on whether the areas identified are likely to add the most value in light of the theories of harm identified and whether other areas of analysis would be appropriate.

27. The hypotheses we have identified at this early stage are:
 - Theory of harm 1: Impediments to customers' ability to effectively shop around, choose and switch products or suppliers, resulting in weak incentives for banks to compete for customers on the basis of price, quality and/or innovation.
 - Theory of harm 2: Concentration giving rise to market power of some banks leading to worse outcomes for customers.
 - Theory of harm 3: Barriers to entry and expansion leading to worse outcomes for customers.
28. These hypotheses encompass the broad range of issues identified by the Market Studies which formed the basis for the market investigation reference. In the following sections we identify discrete hypotheses within these high level theories to highlight competing or complementary explanations for a given theory.
29. There are strong interrelationships between the three groups of theories of harm. For example, as we emphasise below, as well as being a theory of harm in themselves, impediments to customers' ability to shop around, choose and switch suppliers may also act as a barrier to entry. Similarly, high levels of concentration might not give rise to market power in the absence of high barriers to entry and expansion. An AEC finding may be found to have resulted from a single feature or a combination of features. The identification of several theories of harm will therefore not prevent a finding of an AEC based on a combination of features initially identified under separate theories of harm or on another basis.

Theory of harm 1: Impediments to customers' ability to effectively shop around, choose and switch products or suppliers, resulting in weak incentives for banks to compete for customers on the basis of price, quality and/or innovation

30. The Market Studies and other pieces of research into retail banking have extensively documented and raised concerns that there is limited customer engagement in the sector. As set out in the CMA's Guidelines for Market Investigations,²³ to drive effective competition, customers need to be both willing and able to access information about offers available in the market, assess these offers to identify the product that provides the best value for them, and act on this assessment by switching to their preferred supplier or product. If customers are not able to effectively shop around, choose and switch products and suppliers, competition will be weak which is likely to lead to worse outcomes for customers. We refer to this as weak customer response on the demand side. In addition, where there is a weak customer response, suppliers (the supply side) may have an incentive to create and/or enhance impediments to customers' ability to shop around, chose and switch products or suppliers. Such impediments may also act as a barrier to entry or expansion.
31. In assessing this theory of harm we will consider what impediments there are to customers accessing information ('access'), to identifying best value offers and to understanding the true costs of banking products ('assess') and to switching products and suppliers ('act').

Hypothesis 1a (access): lack of accessible and transparent information means that customers do not have the information they need to compare offers or make informed decisions about how they use their existing banking services

32. Under this hypothesis, competitive pressure on banks is reduced because customers cannot easily observe and compare products. This may lead to customers making inefficient or wrong choices. Faced with customers' lack of knowledge and confusion, banks may have reduced incentives to compete on pricing, service and/or quality. Lack of customer awareness may also create a barrier to entry and expansion.
33. A lack of accessible and transparent information may arise because retail banking products are inherently complex or through the unforeseen creation of complexity, for example for historical reasons due to regulation or bank custom. The actions of banks themselves may give rise to such informational

²³ [CC3 Revised](#), paragraph 296.

barriers by retaining more complicated products and pricing patterns to discourage customers from searching for alternative products or suppliers.

34. In addition, limitations on available information may also lead customers to make inefficient decisions about usage of their bank account. For example, if customers do not know when they are going to go into overdraft they may inadvertently incur charges. Banks may as a result face limited competition over the level of charges where customers do not have sufficient information to factor such charges into their decisions on account usage as well as their choice of product and supplier. For SMEs in particular, a lack of transparency would be an important consideration given the charging structures on BCAs and SME lending products.
35. We will obtain information and analyse the level of transparency and information accessibility on PCAs, BCAs and other SME products in relation to pricing including penalty charges, quality and service across banks and over time. We will also look at customer behaviour and how easy or difficult it is for customers to find and compare information and their reasons for considering (or not) switching.

Hypothesis 1b (Assess): Product and pricing structures exploit customers' cognitive limitations and behavioural biases and inhibit their ability to compare offers and understand true costs of banking products

36. Under this hypothesis we will focus on the impediments customers may face in being able to assess the best product for them, understand the true costs of particular products and the optimum usage once they have chosen the product. This may arise as a result of cognitive limitations and behavioural biases due to prevailing product and pricing structures. For example, customers may underestimate their chances of going into overdraft when choosing their bank and their account type and may not, as a result, focus on overdraft charges. These limitations and biases may be caused or exacerbated by free core current account services (debit accounts and money transmission services) for PCAs and equivalent initial offers on BCAs. Similarly, customers may underestimate the likelihood of keeping large credit balances on their current account and may as a result forgo interest on such credit balances by retaining their funds in a non/lower-interest paying account.
37. These limitations may also lead to certain supply-side responses both within products (eg free in credit current accounts bundled with an overdraft facility) and across products (eg the cross-selling of add-on products from their PCA/BCA provider). Banks may not have an incentive to move away from established pricing structures, for example free in-credit banking coupled with overdraft charges compared with fee-paying accounts. This may enable

banks to exploit customer behavioural biases leading to higher prices (for example, overdraft charges) or reduced quality and differentiation (for example, non/lower-interest paying accounts) compared with a well-functioning market.

38. We will consider which behavioural biases are relevant in the sector and the extent to which they are exploited by the banks by analysing customer behaviour (including account usage and customer perceptions), reviewing banks' strategies and their product and customer revenue and profitability. Recent developments such as the introduction of buffer zones, text alerts and overdraft opt-outs (PCAs) will also be assessed as to their impact on customer behaviour.

Hypothesis 1c (Act): Costs and risks of switching and the absence of prompts due to the evergreen²⁴ nature of banking products, act as a disincentive for consumers to shop around and switch

39. Even when consumers can access and assess information about their account and other products, they may not act on this information by switching products and/or suppliers. As a result, banks may have the ability to raise prices and/or reduce quality and/or innovation. There may be switching costs which may mean that there needs to be significant benefits to switching in order to prompt customer action. Such costs may include the time it takes to switch and the risk that something may go wrong. For PCAs in particular, customers may have concerns over the impact on their credit rating from switching too many times or enquiring about particular products. For SMEs, there may be particular costs associated with switching secured borrowing and losing long-term banking relationships with their provider.
40. There may also be perceived switching costs which may be greater than the reality of switching. Other factors may also influence switching, such as the lack of a trigger for switching PCAs or BCAs compared with other financial products (such as insurance products, which have annual renewals) or perceptions that incumbent banks are 'safer' than smaller and newer banks.
41. We will seek information on the actual costs and risks associated with switching PCAs and BCAs, customer-perceived costs and benefits (or lack thereof) of switching, the impact of CASS and other recent initiatives, and the role of borrowing as well as the effect of multi-banking and partial or gradual switches. For BCAs, issues related to customer churn and the costs and risks

²⁴ Evergreen products involve a rolling contract without an end date in contrast to services involving annual contracts, for example insurance.

associated with new customers will also be particularly relevant as well as the extent of negotiation between banks and customers on terms. Comparative analysis of switching in other countries and/or industries may also be helpful in this context.

Theory of harm 2: Concentration giving rise to market power of some banks leading to worse outcomes for customers

42. In general, a highly concentrated market may indicate that one or more firms have market power. Competition may be weak because a firm with a high market share might have less incentive to compete vigorously for certain products, for certain customers and/or in certain geographic markets. There may be a large number of competitors but the market may nevertheless be concentrated with a small number of competitors having most of the customers. Market power may be exercised either unilaterally (whether by a single firm or a number of firms acting independently) or through a number of firms acting in a coordinated way, either of which may result in higher prices or a reduction in quality and/or innovation.
43. Both the SME and PCA Market Studies found that the provision of PCAs and of retail banking services to SMEs was concentrated, notwithstanding the large number of banks and other providers authorised to provide such services. The Market Studies also found that levels of concentration had remained relatively stable over a significant period of time. This is notwithstanding significant developments in the sector over the relevant period, in particular the financial crisis from 2007 onwards which impacted on the financial viability of many providers throughout the UK including RBS and HBOS. Consolidation has continued to be a feature of the sector, with changes in market shares largely arising through mergers and acquisitions rather than organic growth.²⁵ There has been more recent new entry and we will consider ongoing developments such as the current divestments by LBG and RBS.
44. Building on the Market Studies, we will undertake our own investigation of industry structure including market shares and market concentration and whether shares have remained stable over time. We will consider the strength of the competitive constraint between firms within the market(s) and from firms outside the relevant market(s).

²⁵ For example, LBG's acquisition of HBOS and Santander's acquisition of Abbey National, Alliance & Leicester and Bradford & Bingley.

45. If we find that some banks are likely to exert market power, we will consider what impact this has on customers. We will consider this separately for PCAs, BCAs and other SME products including, potentially, sub-segments of customers and between geographic markets. We will wish to consider in particular the banks' pricing and pricing strategies, the profitability of particular customers and products, quality and service levels and the nature of innovation in the sector. The use of international comparisons may also assist us in this analysis.
46. Neither of the Market Studies found evidence of coordination between the banks and we therefore propose to focus our investigation on potential unilateral effects.

Theory of harm 3: Barriers to entry and expansion leading to worse outcomes for customers

47. This theory of harm is concerned with regulatory, structural and conduct barriers to entry and expansion. Entry or expansion by firms will often stimulate competition and the prospect of such entry or expansion within a short timescale can often countervail against a finding of market power and an AEC. Entry and expansion can upset established patterns of market conduct by incumbents, promote efficiency and lead to product innovation as well as reduced prices and greater choice and quality for customers.
48. Barriers to entry will be particularly important to our assessment of whether concentration is leading to market power of some banks under theory of harm 2. In addition, as identified in theory of harm 1, impediments to customer engagement and switching may be a significant barrier to entry and expansion and this will be considered as part of our assessment of theory of harm 1. In this theory of harm 3, we focus on additional potential barriers to entry and/or expansion.
49. Whilst there have been a number of new entrants both in the provision of PCAs, BCAs and other SME products, the Market Studies identified a number of potential barriers to entry and/or expansion, in particular:
 - (a) Regulatory barriers including the authorisation processes for new banks and capital and liquidity requirements in particular in relation to PCAs and BCAs. The Market Studies found that recent reforms of the authorisation process have simplified the process and that similarly steps taken by the PRA since 2013 to reduce capital and liquidity requirements may have at least reduced regulatory barriers.

- (b) Economies of scale, the need for a branch network in order to achieve a significant scale and the costs of establishing relevant IT systems, in particular for PCAs and BCAs. The Market Studies particularly highlighted the need for branch networks as a potentially significant barrier to entry and expansion across retail banking services, whereas they found that historic barriers to entry arising from IT systems were starting to diminish.
 - (c) The need to access finance and payment systems, which may be costly and difficult for newer and smaller providers and, for SME lending, to access customer creditworthiness information. The Market Studies found that access to finance and to payments systems were key challenges for newer and smaller providers. In relation to payment systems, the PSR is currently examining the problems faced by new entrants and smaller banks in accessing key payment systems. The PSR will be shortly announcing its policy proposals to address access arrangements. We will consider the potential impact of these proposals as part of our analysis of payment systems as a barrier to entry and/or expansion.
 - (d) The ability of incumbents to use PCAs and BCAs as a gateway to cross-sell other products either to acquire and/or retain customers. Such cross-selling may increase costs to new entrants who may wish to enter using different models and may also, where such products are profitable, benefit incumbents.
 - (e) The ability of incumbents to use other incumbent benefits and/or practices which may make it harder for new entrants or smaller banks to compete effectively. These benefits/practices may include cross-subsidisation between products and between customers, bundling of products (in particular, between BCAs and SME loan products which will also be a focus of the review of the 2002 Undertakings), delays in granting waivers of security or deeds of priority or restricting other participants from accessing SME banking services.
50. Our analysis of barriers to entry and expansion will in the first instance look at a selection of case studies of past entry and expansion (successful and unsuccessful). We will consider in the case studies the strategies adopted by the firms entering or expanding and of the incumbents, and the costs and lead times for entry/expansion. Subject to these case studies and ongoing regulatory developments, we will also look in more detail at a number of barriers to entry and expansion which, as highlighted above, the Market Studies found were of particular concern. We will, for example, consider whether the physical presence of a bank through a network of branches is important for particular customers and, if so, why and how local and extensive the presence needs to be. This will include assessing technological innovations and

development and the costs associated with establishing such networks. We also intend to gather evidence on the banks' strategies regarding the use of PCAs and BCAs as gateway products and on product and customer profitability.

Conclusions

51. We have highlighted areas in this issues statement where we would particularly welcome parties' submissions. We also welcome views on any areas that we have not covered and note that we may revisit the areas of focus for our investigation should we uncover evidence of potential problems in the course of our investigation.

12 November 2014