CMA Retail Banking Market Investigation: Statement of Issues

Response from the New Economics Foundation

The New Economics Foundation (NEF) is an independent and non-partisan research institution which applies economic analysis to the improvement of social, economic and environmental outcomes. NEF welcomes the announcement of a full investigation by the Competition and Markets Authority into the retail banking market. We are grateful for the opportunity to respond to this initial Statement of Issues.

NEF has been engaged with these issues for many years and has published numerous research reports relevant to the remit of this investigation. Below we provide links to some key publications:

- Quid Pro Quo: Redressing the privileges of the banking sector (2011)
- Stakeholder Banks: Benefits of banking diversity (2013)
- Submission to the Treasury Select Committee's inquiry into SME lending (2014)
- Submission to the Treasury Select Committee's inquiry into competition and choice in the banking sector (2010)

In this submission we respond briefly to the key sections of the Statement of Issues, drawing on the findings of our research, and suggest additional areas which we believe the investigation should focus on. We would welcome the opportunity to discuss these findings with representatives of the CMA.

Market definition

We note that the paper says the CMA will "consider whether … the product market should be widened to include any substitute products" for personal current accounts and SME banking services, such as peer-to-peer lending. We believe it is critical that this investigation takes a broad and open-minded approach. The question should be whether customers have access to an appropriately diverse range of products and providers that meet their needs – not just whether there is sufficient competition between a narrowly defined set of traditional banking products and providers which currently dominate the market. The consumer, rather than the incumbent providers, must be the starting point for analysis.

We also note the CMA's conclusion that "previous studies have not identified separate local or regional markets for retail banking services" and that the UK (or England and Wales, Scotland and Northern Ireland) is likely to provide the relevant boundary for analysis. Nevertheless, we hope that the investigation will consider the local and regional geography of the UK retail banking market – for example, whether some areas are particularly under-served by traditional banks – since this is vitally important to the question of whether the market is meeting consumer needs. Research by the Campaign for Community Banking Services suggests that branch closures by the 'big four' UK banks have left 900 communities with access to only one bank, and therefore no effective competition or choice, while 1260 communities have lost all access to bank branches.[1]

In addition, in our view the absence of a thriving local banking sector is one of the key problems with the UK banking system, and has clear links with the decline of competition via the consolidation of the industry in to a small number of large national players. As the paper notes, this consolidation has "largely aris[en] through mergers & acquisitions rather than organic growth". Empirical evidence suggests that locally focused banks, particularly those owned by or on behalf of their customers (known generically as 'stakeholder banks'), perform better than large national or international banks in meeting the banking needs of SMEs.[2 3 4 5 6]

Local banks can maintain intimate knowledge of local people and the local economy, and evidence suggests that they are better than commercial banks at seeking and assimilating the 'soft' information needed to holistically assess the prospects of small firms. Often described as 'relationship banking', this approach ameliorates the information asymmetry which makes SME lending unattractive to larger banks, where the drive for process efficiency and control leads to centralised systems of credit scoring that become blind to regional, local and firm specific conditions.[7,8] It would be unfortunate if the investigation's remit were restricted in a way which prejudged these important questions.

Diversity of business models and ownership structures

More generally, we suggest it is important that the inquiry considers the business models and ownership structure of the banking system. This is because (a) genuine competition and choice requires a diversity of providers for consumers to choose from, rather than simply a larger number of major players following the dominant plc banking model; and (b) the lack of competition in the retail banking market cannot be understood in isolation from the evolution of existing major banks' structure and business models.

The benefits of corporate diversity in banking are widely recognised, and the 2010 Coalition Agreement included a commitment to promote greater diversity. Yet the 'D-Index' of corporate diversity in banking, developed by Professors Michie and Oughton, suggests that it is in fact declining.[9] In our view, of particular importance is the question of whether the market includes viable alternatives to commercial banks with the main objective of maximising shareholder value. NEF's 2013 report 'Stakeholder Banks' identified four main types of these banks globally; co-operative banks, credit unions, public savings banks and CDFIs (Community Development Finance Institutions). We found evidence that such banks tend to display a greater focus on the needs of customers, including more competitive products, better service, and longer term lending; and often have an explicit aim to provide for customers who are under-served by commercial banks.

The UK is highly unusual in lacking any significant presence of this form of bank. Indeed, as the updated 2014 D-Index makes clear, the recent change in ownership of the Co-operative

Bank has exacerbated the situation.[1] This investigation represents an important opportunity to explore this issue as part of a more holistic assessment of competition in the UK retail banking market.

Our 2014 submission to the Treasury Select Committee details how the dominance of 'transaction' over 'relationship' approaches in corporate finance, whilst economically rational for individual banks, has contributed to a lack of funding for SMEs. The expensive distribution networks required for SME lending - branches and highly skilled local loan officers - are unattractive to very large banks relative to activities with lower cost to income ratios, such as mortgage lending or loans to larger firms and to the financial sector itself, and SME lending does not offer the potential to meet the growth expectations of banks with large balance sheets. Again, this points toward the need to consider the breadth of alternatives to the commercial banking sector, rather than simply the level of competition within this sector.

Theory of harm 1: Impediments to customer switching

We agree with the CMA's assessment that "limited customer engagement" and lack of transparency are issues which should be investigated. We consider some of these factors in our 2011 report 'Quid Pro Quo'.

As above, we believe that the CMA should consider impediments to customers switching to alternative forms of provision to meet their financial needs, rather than simply to switching between traditional commercial banks.

For example, in relation to hypothesis 1b – that "product and pricing structures exploit … behavioural biases", we suggest that the illusion of 'free current accounts' is a key example of this and that this may inhibit the growth of alternative forms of provision (such as credit unions) which entail higher explicit fees but may nevertheless offer better value for many consumers, particularly those likely to incur large overdraft fees. Of course, the distributional implications of these pricing structures are also important, since better-off clients are effectively subsidised by the less well-off, who are also least likely to have the time and resources to contemplate switching.

Theory of harm 2: Market concentration

We agree that market concentration is an issue for investigation – although, as above, we would suggest it is far from the only, or even the most important, problematic feature of the UK retail banking market. We would also urge the CMA to explore the connections between increasing market concentration and other trends such as deregulation and demutualisation. The D-Index uses two measures of market concentration – the Hirshman-Herfindahl Index and the 5-firm concentration ratio – as a component of the composite index, and thus illustrates how this can be incorporated into a coherent analytical framework which considers diversity in a broader sense.

[1] BSA (November 2014). Corporate diversity in financial services: An updated index. Available at http://www.bsa.org.uk/document-library/information/publications/corporate-diversity-in-financial-services/

In particular, the authors note that historical trends in the data on market concentration – in particular, the different trajectories of the mortgage and deposit sides of the market in the 2000s, as well as the sharp decline in competition post-2008 – underline the importance of *"distinguishing between 'good' competition and 'bad' competition, "that exploits customer unawareness or, for example, creates a race to the bottom on lending standards" (ICB 2011, p. 153). To be effective, competition must be sustainable; one of the lessons to be learned from the development of the sub-prime market and new funding models is that 'bad' competition can result ultimately in more, rather than less, concentrated market structures. The funding model adopted by new entrants was unsustainable and as the ICB (2011, p163) has noted, "[w]hen the crunch came, the incentives for risk-taking went into reverse with calamitous consequences."*

Theory of harm 3: Barriers to entry

We agree that new entrants to the UK retail banking market face significant barriers to entry. These are discussed in detail in our 2011 report 'Quid Pro Quo'. One particularly critical barrier which is not discussed in the Statement of Issues is the 'Too Big To Fail' (TBTF) subsidy enjoyed by very large banks: i.e. the fact that they are able to borrow at lower costs because markets view them as lower risk, given the likelihood of a taxpayer bail-out in the event that they fail. The Independent Commission on Banking, which recommended the ringfencing of retail banking from investment banking, acknowledged that this would only reduce, and not eliminate, the TBTF subsidy.[10] NEF's most recent research, following the methodology developed by Andy Haldane at the Bank of England, quantifies the TBTF subsidy at £37.7bn for the UK's four largest banks.[11]

Our report also identifies some of the wider advantages enjoyed by the banking sector, such as:

- Subsidised deposit insurance
- Access to the Bank of England as lender-of-last-resort
- Privatised gains and socialised losses.

We are particularly pleased that the CMA has identified access to the payments system as a potential barrier to entry. In our view this is one of the most significant barriers to entry for providers of retail banking services.[12] Smaller financial institutions, including mutuals and credit unions, have to pay significant fees to banks to gain access to the UK inter-bank payments system, which is necessary for them to conduct deposit-taking and lending activity. Our Treasury Select Committee submission recommends the establishment of two or three officially recognised providers of back office infrastructure and related services to create a level playing field for new and smaller providers of banking services.[13]

We would caution against an over-emphasis on regulatory barriers to entry: this needs to be balanced by recognition that deregulation since the 1980s has, paradoxically, led to less competition and diversity rather than more. Policy has permitted an ever more homogeneous and top-heavy sector to develop. Consolidation, takeovers and aggressive acquisitions have left the UK economy with fewer banking institutions, while the impacts of these trends on financial stability and competition were neglected. Arguably, it is the 'market discipline' of shareholder value, not the iron hand of regulation, which has produced such a homogenous and uncompetitive sector. This perspective on recent history is important if the CMA wishes to prescribe remedies which help to make the retail banking market more diverse, resilient and consumer-focussed, rather than repeating the mistakes of the past.

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[1] See http://www.communitybanking.org.uk/report_reduction_2014.htm

[2] See Prieg, L. and Greenham T. (2012) Stakeholder banks (London: NEF)

[3] Cole, R., Goldberg, L. & White, L. (2004). Cookie-cutter versus character: The micro structure of small business lending by large and small banks. The Journal of Financial and Quantitative Analysis, 39(2): 227-251.

[4] Clarke, S. (2012). Street Cred: local banks and strong local economies. London: Civitas.

[5] European Association of Cooperative Banks. (2010). Latest key figures on the sector [webpage]. Retrieved from http://www.eacb.eu/en/cooperative_banks/key_figures/last_key_figures.html

[6] Credit Union Central of Canada. (2012). Exploring the relationship between credit unions and the small business sector: facts, figures and future prospects. System brief. Retrieved from http://www.cucentral.ca//_layouts/download.aspx?SourceUrl=http://www.cucentral.ca/Publications1/SYSTEMBrief_Small_Business_June_2012v1.pdf

[7] Berger, A., Miller, N., Petersen, M., Rajan, R. & Stein, J. (2002). Does function follow organizational form? Evidence from the lending practices of large and small banks. Journal of Financial Economics, 76(2): 237-269.

[8] Banking taskforce (2012). Appals process: Independent external reviewer. Annual report. Retrieved from http://www.betterbusinessfinance.co.uk/images/uploads/Annual_Report_Master_2012.pdf

[9] Michie, Jonathan, and Christine Oughton. "Measuring Diversity in Financial Services Markets: A Diversity Index." Centre for Financial and Management Studies Discussion Paper Series 113 (2013).

[10] See Prieg, Greenham & Ryan-Collins (2011). Quid Pro Quo: Redressing the privileges of the banking industry. (London: NEF), p63

[11] Figures released December 2013: see http://www.neweconomics.org/press/entry/37-7bn-taxpayer-reward-for-the-big-four-banks-but-what-do-we-get-in-return

[12] See also comments to this effect by Andy Haldane: *Financial Times*, November 7 2012, "Haldane calls for common bank infrastructure", http://www.ft.com/cms/s/0/7e09a236-28d9-11e2-9591-00144feabdc0.html#axzz2wzerSmyG

[13] For example the kind of service offered by Tusmor. See http://www.tusmor.org/