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Dear Professor Smith

CMA: Retail Banking Market Investigation – Statement of Issues Consultation

We welcome the opportunity to respond to the Statement of Issues for the Retail Banking Market Investigation. We are pleased to attach our initial thoughts on the sector characteristics, market definition and hypotheses for investigation (theories of harm) set out in the paper.

As a medium-sized challenger bank which has recently entered the market for personal current accounts, we have a particular interest in this issue. Earlier this year, Virgin Money launched a basic bank account, intended to be the first in a range of PCA products. Virgin Money recognises that PCAs can be important in developing long-term customer relationships and can act as a gateway product.

We are not currently active in SME banking, but we agree that personal current accounts (PCAs) and business current accounts (BCAs) have similar characteristics and that the investigation should consider PCAs and BCAs at the same time.

Our vision for Virgin Money is a full-service retail bank that is able to compete effectively on a level playing field with the large incumbent banks. However, we believe that a level playing field does not currently exist. This is why we strongly supported the CMA's decision to make a Market Investigation Reference (MIR), which we believe is necessary if we are to create a more competitive personal current account market that better serves the needs of consumers.

We believe that the CMA investigation of the retail banking market should focus on the following interlocking issues, all of which play an important role in inhibiting competitive forces in this sector, and act as important barriers to entry and expansion for smaller banks:

- the lack of transparency and complexity of charging structures for particular features of PCAs, combined with the dominant free-if-in-credit model which makes it difficult for new entrants to compete on price or through more innovative product offerings;
- customer inertia, which is related to the lack of diversity in the market and the fact many consumers see little real difference between providers and products;
- the ability of the large incumbent banks to use their dominance of the PCA market to build long-term relationships with consumers and use PCAs as a gateway to cross-sell other products;

- lack of fair and open access to payment systems for smaller banks which have to access the system via agency agreements with larger banks, combined with the disadvantages resulting from the large banks ownership of the payment systems; and
- the introduction of CASS, which whilst welcome, has failed to address many of the concerns and confusion customers still have about switching their current account and places a continuing burden on businesses to update customer records to ensure payment.

A consequence of the first factor is a distortion in the market for PCAs, as a result of which the large incumbent banks can take advantage of the inertia of their customers to achieve significant cost of funds benefits arising from low customer rates on deposits, and use these stable deposits to support assets.

Another consequence of the factors outlined above, is that switching levels remain low. We have suggested previously that consideration should be given to the introduction of account number portability (ANP), facilitated by a movement towards a shared payments infrastructure. These initiatives could help to address some of the barriers to entry that have been identified in the Issues Statement, and which we have mentioned above, through for example enabling fairer and more open access to key payment systems, and encouraging easier, quicker and more reliable switching.

We note that the FCA is currently reviewing the effectiveness of the CASS and will, alongside this, commence a study of the costs and benefits of ANP. The FCA has stated that the evidence it gathers on ANP will inform the work that the new Payment Systems Regulator (PSR) intends to undertake in relation to payments infrastructure. We welcome these developments. We also welcome the commitment of the PSR to coordinate with the CMA's investigation, as we believe it is crucial for the CMA to consider these issues as part of its own holistic investigation of the market.

In summary, we believe that a pro-consumer and pro-competition approach is the best way to deliver sustainable and tangible benefits to consumers. A more competitive market in personal current accounts would provide consumers with a better and more diverse choice of products and services and would stimulate greater innovation than has hitherto been the case.

We therefore welcome the investigation by the CMA of the supply of retail banking services to PCA customers and to SMEs, and will be happy to contribute to the investigation. In particular, we shall be happy to arrange site visits, provide information about our own experience and attend hearings in due course.

Yours sincerely

Jayne-Anne Gadhia
Chief Executive Officer
Virgin Money

Virgin Money response to the Competition and Markets Authority (CMA) Retail Banking Market Statement of issues Consultation Paper

1. We welcome the opportunity to respond to the CMA's Retail Banking Market Investigation Statement of Issues Consultation Paper in respect to the PCA market, in which we have a keen interest. Virgin Money wishes to complete its retail banking customer proposition by offering PCAs. Earlier this year, Virgin Money launched a basic bank account, intended to be the first in a range of PCA products.

2. We believe that the personal current account (PCA) market is not delivering good outcomes for many groups of consumers and that this reflects a lack of competition between the banks with large PCA market shares and barriers to entry and expansion in PCAs by smaller banks and new entrants.

3. We therefore supported the CMA's decision to make a Market Investigation Reference (MIR) with respect to the PCA market and we support the approach that the CMA has proposed taking to its Retail Banking Market Investigation, as set out in the case timetable.

4. In particular, we believe that the PCA market needs real change rather than minor reforms, and have some views on how real change might be achieved – including open and fair access to payment systems and account number portability. But we agree with the need first to gain a proper understanding of the PCA market by considering the sector characteristics set out in the Statement of Issues Consultation Paper, and how they might inhibit competition and innovation and lead to worse outcomes for consumers.

5. We are therefore pleased to set out below our thoughts on the sector characteristics, market definition and theories of harm that were set out in the Consultation Paper. Whilst our comments in this response are focussed on the PCA market, we think that many of the points that we make also apply to the business current account (BCA) market.

6. We shall also be pleased to provide any further information that you require, and to arrange site visits on matters relating to the investigation.

Market definition

7. We think that the PCA market is a single market across Great Britain. A PCA is a distinct product, for which there is no substitute. A consumer in any part of Great Britain may have a PCA at any branch in Great Britain. The pricing of PCAs by any bank is, as far as we are aware, uniform across Great Britain.

8. Although we think that the PCA market is national, there are some local characteristics. The sort code on cheques reinforces the fact that PCAs are branch-based, and surveys show that access to a local branch is an important factor for consumers choosing a PCA provider.

9. Whether PCAs and BCAs form a single market or not, we see logic in considering both PCAs and BCAs in this investigation. PCAs and BCAs share the characteristics of being long-term relationship products which are important for economic activity and growth. In both PCAs and BCAs, switching is low, there are barriers to entry and expansion, and consumers would benefit from greater competition and innovation.

10. While we think that PCAs (or PCAs and BCAs) form a single market, we recognise that there are linkages to other products which banks cross-sell to their current account customers, as recognised in sector characteristics (c) and (f) which we discuss further later in our submission.

Sector characteristics

11. We believe that the sector characteristics identified by the CMA can, to varying degrees, help explain features of the market which have had, or are having, an adverse effect on competition

and are leading to worse outcomes for consumers. Furthermore, we believe that many of these characteristics are interlocking and some characteristics identified may be symptoms of other deeper underlying characteristics of the market.

12. We believe, with respect to the ten characteristics outlined by the CMA, that:

- **the activities of retail banks are highly regulated (a):** we agree that the activities of retail banks should be highly regulated both to maintain the financial stability of the banking system and to protect consumers. The regulatory authorities have, however, taken steps – the authorisation process has been simplified and capital requirements for new banks have been reduced – which should have positive consequences in terms of barriers to entry and growth in the PCA market.

- **If in credit, PCAs are generally free for customers (b)**: PCAs are free for those consumers who remain in credit and many consumers have thereby benefited through not having to pay for their personal current account. However, firms have, at least in part, used overdraft and other ancillary charges as a source of revenue to help meet the cost of current account provision. This has inevitably entailed cross-subsidisies between consumer groups, with consumers who remain in credit cross-subsidised by those consumers who run overdrafts or incur other charges. Such cross-subsidies may distort the market. They certainly exacerbate opacity and this serves to further erode consumer trust in providers. Furthermore, the persistence of such cross-subsidies over time, as Sir Donald Cruickshank has previously told the Treasury Committee, are themselves indicative of a market where competition is not working in the interests of all consumers.

  We believe that the free-if-in-credit characteristic of the PCA market, whilst popular with many customers and with consumer groups, is an important explanation of why competition does not work well in the personal current account market. The combination of the lack of a headline price for personal current accounts, along with with the opacity and complexity of charges for additional account features, such as overdraft charges (which we discuss further in our response to characteristic (e)), means that, unlike in most markets, prices and price changes do not drive competition in this particular market.

  We believe that an examination of the role free-if-in-credit banking plays in restricting competition in this market as well as the distributional consequences of this model of current account provision should play a role in the CMA's inquiry.

- **Customers generally prefer to use a single bank to meet the majority of their banking needs (c)**: We do not believe that personal customers consciously prefer to use a single bank to meet all their retail banking needs. Indeed our experience demonstrates that many personal customers prefer to spread risks across a number of banks.

- **Customers consider that there is little differentation between providers and switching remains relatively low (d):** We agree with this characteristic of the market as identified by the CMA. One important reason for this lack of differentation is the constraints imposed by the need to interface with a range of payment systems rather than having the ability to innovate and differentiate through interfacing with a central system that would allow individual banks to choose features that would allow them to tailor products to the needs of specific customer groups.

  With respect to the lack of differentation and low levels of switching between providers, we believe that this is linked to the market characteristics discussed under (a) and, in particular, (b) and (e), all of which serve to either reduce the ability of banks to differentiate themselves from one another or serve to make it difficult for consumers to compare alternative providers and product offerings.

- **Many products and charging structures can be relatively complex (e):** The CMA has correctly identified complexity of products and charging structures as issue with the consequence, which we agree with, that "customers may find it hard to understand the true costs of products and to compare different products". However we could go further and say charging structures are not just complex, but are also often opaque and take advantage of limited engagement by consumers. As we discussed in our answer to market characteristic (b) and (d) above it is extremely difficult for consumers, in the face of such opacity and the complexity of charges, to compare rival offerings and this means that price signals do not drive competition in this particular market.

We believe that the CMA should examine whether this complexity and lack of transparency is an inherent feature of the free-if-in-credit model of provision. Our suspicion is that they may be, because numerous OFT attempts to get the banks to simplify product and charging structures have largely failed.

The OFT Market Review showed that, while insufficient funds fees had been reduced, banks had offset this fall in their income by increasing other PCA charges and by introducing new charges. Also, the recently-introduced charging structure on overdrafts (e.g. £1 per day) creates cross-subsidies between different groups of overdraft customers and leads to high effective annual interest rates on small overdrafts.

- **There are significant linkages between products (f):** This market characteristic is connected to characteristic (c) of the market as discussed above. Certainly, the large incumbent banks view the PCA as a 'gateway' product and an important means to build a broader relationship with customers and the information they obtain about their PCA customers enables them to cross-sell other products to them.

  It has been suggested by, amongst others, Lord Turner, that the personal current account may be akin to a loss-leader for some banks.[1] But that banks are prepared to allow this because of the significant opportunities it gives them to cross-sell additional products to consumers.

  We believe an examination of whether the personal current account is a loss-leader for the banks and, if so, what specific advantages they derive from this, should form an important part of the CMA's investigation.

- **Both the SME and PCA banking sectors are relatively concentrated throughout the UK (g):** We concur – the personal current account is clearly dominated by the four largest banks who account for almost 80% of the market. This dominance has been maintained over a significant period of time. This is despite the events of the last few years, for example, IT failures, mis-selling of products to both personal and small business customers and relatively low customer satisfaction levels, which have all to varying degrees affected the large incumbent banks. These developments might have been expected to encourage increased levels of switching and thereby lower concentration levels, but this has not happened to any significant extent. The stable PCA market shares of the banks with large PCA market shares, despite their problems, provides a strong *prima facie* indication of weak competition in the sector.

  Weak competition between the banks with large PCA market shares may reflect a rational preference of these banks to maintain the status quo rather than to compete aggressively. The status quo enables them to have the prospect of cross-selling other products over the long lives of their PCA customer relationships. Under aggressive competition, they would have more to lose than to gain, especially if they allowed new banks to enter and expand in the PCA market.

- **The four largest banks in particular have extensive local branch networks (h):** Whilst the CMA is correct that "such networks appear to be important for a significant proportion of

[1] Lord Turner, oral evidence to the Treasury Committee inquiry *Competition and choice in retail banking,* 23 November 2010, Q 48

customers", we believe that this sector characteristic is of declining importance for many retail banking products. This is largely due to the growing popularity of alternative distribution and money management channels such as the internet. However, in PCAs, OFT surveys have shown that the presence of a local branch is an important reason for customers choosing a PCA provider, possibly because it provides convenience and reassurance.

- **New entrants require access to a number of key inputs such as finance, IT, customer creditworthiness information and payment systems (i)** We believe that payment systems can act as an important barrier to entry and growth for banks which have to access the payments system through agency agreements with the large incumbent banks. In our response to the FCA consultation on the establishment of a new Payment Systems Regulator, we stressed the importance of examining the extent to which the large incumbent banks, which are the principal users of the systems, but also co-operate as principal owners, have, or could, create barriers to entry and expansion through their membership requirements for the major payment schemes or through the terms and conditions on which they offer indirect access to those schemes.

Hypothesis for investigation (Theories of harm)

13. In this section we consider, for PCAs only, the extent to which the sector characteristics identified in the *Statement of issues* support each of the three theories of harm put forward in the paper. In doing this, we consider those sector characteristics which we believe to be most important in explaining each theory of harm.

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

(b) (e) Free-in-credit banking, complex charging structures:

14. The free-in-credit banking model serves some customers extremely well and is popular with consumer groups. This is despite the fact that for some consumers it is not free and despite the cross-subsidies between different groups of customers.

15. However, the combination of free-in-credit banking, interest foregone on credit balances, insufficient funds and other charges, including those on overdrafts, and (relatively high) interest rate charges on overdrafts can make it difficult for consumers to assess the true overall cost of PCAs. In addition, because the true overall costs of PCAs depend on consumers' behaviour, it is very hard to assess and compare the costs of PCAs offered by different providers. Also, whether intended or not, the charging structure may well take advantage of consumers' bias towards optimism that they will not suffer overly from interest foregone or pay insufficient funds charges.

16. Certainly, the PCA market does not currently seem to be delivering good outcomes for those customers who have overdrafts or large credit balances, or who pay insufficient funds and other charges, because they are subsidising the customers who enjoy genuinely free banking.

17. Demand side issues may also play a role. There appears to be limited customer engagement with this part of the retail market, which may in part be explained by some of the factors mentioned in the previous paragraph. It may also be the case that, despite the introduction of CASS, many consumers consider that switching may be a hassle and/or perceive that the potential benefits of switching are not worth the problems that will arise if the switching process goes wrong. Equally, many consumers may perceive that the costs of switching (search costs and time taken to switch) may outweigh the benefits – this may be particularly true in a low interest rate environment.

18. The combination of complex pricing structures and consumer inertia may be an important determinent of low switching levels in the PCA market, leading to weak incentives for PCA providers to compete on price, quality and/or innovation.

(d) Low switching:

19. The introduction of CASS, which whilst welcome, has failed to significantly increase switching levels. It may have failed to address the concerns customers still have about switching their current account. As a consequence of this, as well as other issues outlined in this submission, switching levels remain low. We have suggested previously that consideration should be given to the introduction of account number portability (ANP), facilitated by a movement towards a shared payments infrastructure.

(c) (f) Single bank, linkages between products:

20. The expectation that PCAs will be long-term - and possibly lifetime - products means that, even if accessible and transparent information were available, many customers might still have no interest in shopping around for a better PCA provider. For customers who are willing to consider consider switching, the lack of accessible and transparent information makes shopping around difficult and discourages switching. Both these behaviours work to the advantage of banks with large PCA market shares because they can cross-sell other, more profitable products to their PCA customers. This underlines the need for a switching service, such as ANP, that would increase the ease and reliability of the switching process.

Conclusion for Theory of harm 1

21. We believe that this hypothesis is supported by many of the sector characteristics and that it should be investigated. The combination of complex charging structures, limited customer engagement and the perception that switching may be problematic may well form a principal cause of low switching and weak competition in PCAs. Additionally, the long-term nature of PCAs, as well as the important role the PCA can play in forging strong long-term relationships with consumers, works to the advantage of banks which have large PCA market shares and can cross-sell other products to their PCA customers.

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

(g) Concentrated market:

22. The PCA market has become increasingly concentrated as a result of the consolidation in UK banking over the last twenty years, and even more concentrated as a result of the acquisition of HBOS by Lloyds TSB and other acquisitions around the time of the banking crisis. The impact of these recent acquisitions will not be offset by the LBG and RBS divestments.

23. In retail banking as in many other markets, large market shares give advantages through economies of scale, for example in processing and marketing. However, new entrants have been able to compete effectively with incumbents with large market shares in markets such as supermarkets and motor insurance. But these are 'transactional' markets, where consumers choose their provider each week or each year. A fundamentally different characteristic of PCAs is that they are 'relationship' products, which most consumers expect to have for a long time.

24. This characteristic gives power to banks with large PCA market shares, through the expected annuity effect of retaining PCA customers and cross-selling other retail banking products to PCA customers. Individually, this provides weak incentives for the large banks to compete and innovate to retain or build their market shares, while, for the large banks collectively, maintaining the status quo can seem a better option than aggressive competition. The fact that there has been little change in the PCA market shares of large banks that have experienced significant financial, conduct and IT problems over the last five to ten years suggests that consumers are not benefiting from competition and innovation in this market.

(h) Branch networks:

25. OFT surveys have suggested that the large banks have gained market power in PCAs from their extensive networks of local branches, because the convenience of a local branch has been an important reason for choosing a PCA provider. Although PCAs can be opened (and anti-money laundering check made) online, a face-to-face meeting in a local branch may provide convenience in completing the application form and providing proof of identity, and reassurance that the account has been opened). Additionally, given the long-term and possibly lifetime nature of PCAs, some customers may prefer a large bank that they assume will be there for a long time.

(b) (e) (c) (f) Free-in-credit banking, complex charging structures, single bank, linkages between products:

26. As we discuss in paragraphs 14-18, the free-in-credit banking model, with complex charging structures, makes comparison of PCAs and shopping around difficult, and this, together with the preference of some customers to use a single bank and the opportunities that PCAs provide to establish long-term relationships and cross-sell other products, may well confer power on banks with large existing market shares in PCAs.

27. A further important consequence of the free-if-in-credit model is a distortion in the market for PCAs, as a result of which the large incumbent banks can take advantage of the inertia of their customers to achieve significant cost of funds benefits arising from low customer rates on deposits, and use these stable deposits to support assets.

28. In other markets, participants with large market shares may exercise their power by generating 'excess' profits. In the PCA market, it is possible that banks with large market shares in PCAs generate below-hurdle returns, or even losses, on their PCAs, but make adequate returns overall by cross-selling other, more profitable products to their PCA customers – that said, it is difficult to assess the PCA profitability of the large providers because of the complex charging structures on PCAs and the uncertain allocation of large amounts of shared costs.

(a) (d) (i) Regulation, low switching, access to inputs:

29. Whether or not the large banks gain market power from their high and stable PCA market shares, we believe that they collectively gain market power from the barriers to entry and expansion which are considered below (see our response to Theory of harm 3). Among these barriers, low switching in PCAs makes it difficult for new entrants to gain sufficient market share within a reasonable period to justify the necessary up-front investment.

30. In our submission to the Parliamentary Commission on Banking Standards, we pointed out the only two firms had achieved consistent growth in their market shares, from low levels: Nationwide and, to a lesser extent, Co-op Bank, both of which are clearly different from the large incumbent banks. Their success supports our view that the PCA market would benefit from greater diversity and that real change in the PCA market is more likely to come from firms such as these and from new entrants than from the large incumbents (see our conclusion for Theory of harm 3).

Conclusion for Theory of harm 2

31. We believe that this hypothesis is supported by the sector characteristics and that it should be investigated. In any market where a small number of broadly similar providers each has a high market share, they are likely to be individually more interested in defending their existing market share than in competing aggressively to increase their market share and collectively interested in maintaining the status quo.

32. Such a situation is likely to lead to a lack of competition and innovation and is not likely to lead to the best outcomes for consumers. Characteristics of the PCA sector that are different from other markets include the long-term nature of PCAs, which may confer power on the large

incumbents and reduce their incentive to compete and innovate to deliver good outcomes for consumers.

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

(a) Regulation:

33. Although the authorisation process for new banks has been made easier and initial capital requirements have been reduced, retail banking is highly regulated, and the complexity of the regulations and costs of ensuring compliance with them may still form a barrier to entry and growth in retail banking.

(i) Access to inputs:

34. As noted in various reviews over recent years, access to payment systems may present a barrier to entering the PCA market, given that the large banks, as owners and principal users of the payment systems, have power to influence membership requirements and agency banking arrangements. We supported the establishment of the payment systems regulator (PSR) and recognise that the PSR is looking at payments issues such access arrangements. However, we think that access to payments systems should also be considered by the CMA within its holistic investigation.

(d) Low switching:

35. An important barrier to entering PCAs, recognised in various reviews over recent years, is the low level of switching - even after the introduction of the seven-day current account switching service (CASS). The low level of switching makes it difficult for a new entrant to PCAs, even with a strong consumer brand such as Virgin Money, to be confident that it can achieve sufficient scale within a reasonable period to justify the necessary up-front investment.

36. One reason for low switching is that banks with high PCA market shares may have little incentive to compete aggressively since it may serve them better to maintain the status quo in PCAs and to cross-sell other products to their PCA customers. We believe that greater diversity of PCA providers, including new entrants to PCAs, would enhance competition in this market in ways that are good for consumers, since new entrants would be likely to compete through some combination of more innovative products, lower prices and better service.

(b) (e) Free-in-credit banking, complex charging structures:

37. Although free-in-credit banking serves some customers extremely well and is popular with consumer groups, it makes it difficult for new entrants to innovate and differentiate themselves through offering simpler product variants at lower prices (when taken in the round), in the way that new entrants can enter other markets, expand and eventually force a competitive response from large incumbents in that market.

(h) Branch networks:

38. As confidence in online banking grows, we do not believe that the lack of an extensive branch network presents a significant barrier to entry and expansion in retail banking in products other than PCAs (and SME banking). However, in PCAs, OFT surveys have shown that the presence of a local branch is an important reason for customers choosing a PCA provider, possibly because it provides convenience and reassurance (see our response to (h) under Theory of harm 2).

(c) (f) Single bank, linkages between products:

39. We are not sure whether the preference of some customers to use a single bank is significantly different from other retailing businesses. However, PCAs are different from other products that consumers use because they are open-ended long-term products - often lifetime products. This

characteristic of PCAs and their role as a 'gateway' to other products represent a barrier to expansion by smaller banks and new entrants in the PCA market as well as in retail banking more broadly.

(g) Concentrated market:

40. We have expressed concern about the domination of PCAs by what we see as an effective oligopoly of large banks, and note that large banks with financial, conduct and IT problems have not lost market shares. Not only do large PCA market shares provide economies of scale advantages, but they offer long-term future annuity effects, through cross-selling other products to PCA customers, that the large banks will not want to lose. The large banks may rationally prefer the status quo to real change in PCAs.

Conclusion for Theory of harm 3

41. We believe that this hypothesis is supported by the sector characteristics and that it should be investigated. New entrants are likely to bring better outcomes for consumers since, if not inhibited by barriers to entry and expansion, they are likely to compete with the large incumbent banks through a combination of better products, lower prices and better service.

42. We believe that real change in the PCA market and better outcomes for consumers are more likely to come from new entrants than from the large banks, which have more to lose than to gain, or from the recent divestments, which are constrained by the legacy infrastructure and IT they have inherited.