Joint Submission to Competition and Markets Authority

on the Retail Banking Market Investigation

on behalf of

The Finance Innovation Lab and other signatories below

Entrepreneurs:

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This submission is on behalf of the Finance Innovation Lab, with support from major players in alternative finance, civil society and research organisation, all committed to increasing the diversity of business models in the financial services as one means to transform the finance system into one that serves the interests of society and the wider economy.

We warmly welcome the announcement of a full investigation by the Competition and Markets Authority into the supply of certain financial services to consumers and small and medium-sized enterprises (SMEs). Below are our comments on the Statement of Issues published on 12 November 2014.

Background

It is of critical importance that your investigation adopts the customers' perspective, rather than approaching the market from the standpoint of existing regulated products and their providers. The overall question should be whether customers' financial needs are being met through an appropriately diverse range of services, business models and service providers, rather than just those offered by the major UK banking groups.

In particular, we are concerned by the decision to limit the scope of this investigation to markets for personal current accounts ("PCAs") and general purpose business products including business current accounts ("BCAs") but exclude merchant acquiring, hedging and foreign exchange, as defined in the Statement of Issues. This fails to recognise the extent to which the full range of products has become misaligned with customer requirements, through a combination of unduly rigid regulatory distinctions, inertia, cross-subsidies, incentives and other benefits to the banking groups who offer them. Indeed, there is actually no regulated business (or customer) activity known as 'banking'. It is important to consider merchant acquiring and foreign exchange (as well as invoice discounting), since these are vital to SME cash flow. Merchant acquiring also provides a means for buyers/investors to transfer funds to e-money issuers, as well as e-commerce, peer-to-peer and crowdfunding marketplaces.

In addition, of the five elements comprising a PCA as defined, only cheques and overdrafts are exclusively associated with 'banks' today, while the other elements may be offered by, say, Electronic Money Institutions who issue prepaid cards (and are exempt from the activity of 'accepting deposits' to the extent they issue e-money on receipt of funds). Indeed, all PCAs offered by 'banks' merely represent the bundling of disparate services from multiple entities within each banking group, based on access to interbank systems operated by entities owned or established jointly by the banks themselves. The fact that PCAs, BCAs and merchant acquiring are layered on interbank systems partly explains why banking groups do not attempt to offer significantly different PCA and BCA products.

The cost savings and other benefits derived by banking groups from this bundling become more obvious where, say, a PCA is offered with an associated credit or insurance product requiring monthly payments; or it is made to appear much easier for a sole trader to transfer dividends or expenses from a BCA to a PCA or savings account with the same bank, than when the two sets of arrangements are held with different banks. Similarly, SMEs may be effectively 'locked-in' to packages of products from the same banking group in the context of wider funding arrangements.

The CMA's investigation should therefore focus on the challenges faced by other providers in accessing and combining the payment functionality actually required in the course of the consumers' and SMEs' day-to-day activities, using more up to date technology.

It is instructive, for example, that the proposal for a [new Payment Services Directive ("PSD2")] recognises the possibility of separating the initiation and processing of transactions from the handling or holding of the corresponding funds (which might never actually be withdrawn in an e-money system). In other words, a consumer or SME ought to be able to request payments to creditors out of salary or invoice receipts and the remainder to be deposited into various savings, lending or investing accounts, without those funds actually reaching a 'current account', let alone remaining there as an interest-free loan to a deposit-taker. Equally, it is hard to see why the ability to pay interest, access to clearing services and FSCS cover should be accorded to credit institutions for current accounts and not to e-money institutions for e-money accounts or perhaps payment institutions for payment accounts. There should be a level playing field where the customer merely intends to pay creditors and/or to maintain a small balance to cover any remaining short term needs, rather than to leave larger sums on longer term deposit at higher interest rates. In addition, PSD2 contemplates "account access services", which would enable a customer to see transaction data from multiple accounts at different service providers in the one place.

We are concerned by the assertions in the Statement of Issues that "customers generally *prefer* to use a single bank", "SMEs appear to *value* an ongoing relationship with their bank" and "extensive branch networks… appear to be *important* for a significant proportion of customers" (our emphasis added). We are not aware of any evidence to support the subjective nature of these conclusions. The fact that customers may use a single bank or branches may be explained by: actual or perceived obligation; lack of awareness of alternatives and how to compare them; or simply inertia. But surely these are merely hypotheses among those to be tested in the course of this investigation?

The functional limitations of PCAs, BCAs and other business finance services, and lack of innovation by banks may also drive this customer behaviour. For instance:

- customers may leave unduly large sums on deposit in PCAs and BCAs because they are not certain of the final daily balance at the moment they use a debit card or write a cheque, even if (which is often not the case) a text service is available and it is convenient to request or receive a text at that moment;
- customers may use a single PCA/BCA for all regular payments because in practice they have not been able to view transactions from multiple accounts in one place (as envisaged by the regulation to support the development of 'account access services' in PSD2);
- even where funds arrive relatively quickly in an SME's account through the Faster Payments network, there is often a substantial delay in the arrival of information on the payer via the bank's BCA systems; in some cases SMEs have to pay for two sources of account data from their bank, and related internal systems, to make up for lack of detail in their main account data; others receive their payments data by fax rather than through an application programming interface (API); and frequently the payment data arrives in unintelligible form, necessitating substantial investment by SMEs in software and processes designed to decipher the bank's data to determine which of the SME's customers sent the payment. SMEs may therefore remain with a particular bank to avoid having to repeat the 'work-arounds' and development work required to accommodate the idiosyncrasies of another bank's systems.

The CMA also needs to analyse the total economic cost/benefit associated with PCAs and BCAs, rather than merely fee revenue received directly by banks for offering those discrete services. In that wider context, any claim that banks offer "free current accounts" is utterly misleading. If current accounts were a net cost to banks, then why would they advertise them so heavily? A wider analysis also fails to recognise the extent to which new entrants – even those charging fees – may in fact reduce the overall cost, or increase the overall benefit to customers and the wider economy associated with PCAs, BCAs and other business finance services. The true cost/benefit analysis should take into account: interest foregone by customers through extended payment cycles; funds held on low or zero interest terms; the failure by banks to invest in up-to-date internal systems and the related cost to customers of coping with the receipt of poor quality payments data through outmoded channels; fees for debit card and other payment transactions (including interchange fees and the requirements of the proposed Merchant Interchange Fee Regulation); savings derived by banking groups from bundling PCA/BCA and other service components and using shared inter-bank systems that are not available to competing payment providers; cross-sales and links with other products and services; and the wider cost and implicit subsidy and customer incentives associated with being able to offer interest on PCAs/BCAs, and benefit from the Financial Services Compensation Scheme and the State guarantee of bank liabilities.

There should also be added to the list of regulatory developments in section 19 of the Statement of Issues: the latest proposals for PSD2 and MIF Regulation, mentioned above; the proposed legislation to require banks to refer rejected SME loan applications to designated finance platforms; as well as the specific authorisation for peer-to-peer lending platforms and expansion of the scope for retail investors to participate on crowd-investment platforms from 1 April 2014.

In considering prior studies and reports into retail banking and drawing comparisons with 'banking' sectors in other countries, it will be important to recognise and avoid repeating any associated bias, preconceptions and/or mistaken perspectives and assumptions of the kind discussed above.

The interests of the consumers and businesses who use 'banking' services at the moment may be better served by services offered by mutual building societies, stakeholder banks, peer-to-peer (P2P) lending platforms, crowd-investment platforms, e-money and payment institutions and other online payment service providers, credit unions, community finance institutions or other business models as yet undeveloped.

We urge your investigation to look for adverse effects on market entry and competitive opportunities for these market players against mainstream banking groups, as well as lack of competition among the banking groups themselves.

The barriers to competition which face these other finance market players easily fit into the scope of the issues paper, but there are specific areas where your investigation could look in more detail at the barriers to diversity in the banking market. In each area there are recent research reports for the Authority to review, as well as market players who would be good candidates for site visits and providing more detailed testimony.

Theory of harm 1 – impediments for consumers to shop around and switch products

As already mentioned, the functional limitations of PCAs and BCAs may actually be responsible in part for what is assumed to be customer loyalty. There would also seem to be little incentive to switch when all PCAs, BCAs and banks' other business offerings are more or less the same. This is particularly the case in relation to basic bank accounts. In addition, there is plenty of evidence to show that, in some parts of the country - often low income areas - services provided by high street banks are in serious decline at a time when improved financial services are critical to economic recovery and growth. Many SMEs across the UK also feel neglected by the incumbent banks. As discussed above, the nature of the products being offered, and the often complex and opaque information on fees and charges, mean that existing customers remain on poor deals, and some are simply not catered for at all.

The Community Investment Coalition is publishing analysis of lending data disclosed by the banks as part of a voluntary agreement, which further highlights the problems of access to financial services for low income groups. Small business groups, like the SME Alliance, are collating evidence of mistreatment of small business customers. Civil society groups like Move Your Money also work directly with consumers helping them to switch accounts.

Theory of harm 2 – concentration of market power

We disagree that there is a "large number of banks and other providers authorised to provide" PCAs, BCAs and business finance services, given the size of the UK market, the different demands of a diverse array of customer segments and the breadth of functionality inherent in these sets of products as defined. The fact that they all have very similar offerings also reduces the relevance of the number of providers.

As well as the concentration of market share amongst the major banks in the UK, the investigation should also study the impact of the dominance of one business model, the plc, on service provision. Research from New Economics Foundation shows that other developed economies tend to have a far higher proportion of savings, loans and current account market share held by co-operative, mutually owned or quasi state banks, with different business models and incentive structures. Civitas has looked at the benefits of a more local banking system in Germany and Switzerland. Recent research from Nesta has shown the rapid growth in peer to peer lending, using another business model where customers are in control of the terms relating to the allocation of funds, rather than banks. Leading companies such as Zopa, Funding Circle and Ratesetter are demonstrating over 100% growth in their activities. One can also look at potential for expansion of market share to the building societies, credit unions and community finance institutions, as well as crowd-investment models for securities-based finance, and P2P platforms for invoice discounting, foreign exchange and marketplace finance.

However, it is also important to recognise that the operators of these alternative models must rely on access to BCAs and other banking services against which they compete. This enables banks and their services and systems to constrain innovation and competition, whether intentionally or otherwise. Examples of such constraints include refusing to provide segregated BCAs or 'client account' functionality to P2P marketplaces and lending platforms; withholding merchant acquiring services that would enable buyers/investors to transfer funds more conveniently for use on those platforms; as well as interpreting or creating card scheme rules that seek to control how such cleared funds are used after they have been transferred using a payment card.

Also of concern here are the proposals in PSD2 for centralised and institutional control over technical standards and security measures; and requiring exempt technology service providers to supply their services via financial institutions rather than SMEs and consumers.

The CMA investigation should look into the potential benefits of creating a far more diverse set of players in the market, and many more of them, rather than limiting itself to the dominant plc banking model.

Theory of harm 3 – barriers to entry

More diverse competition with banks would also mean tackling the barriers to entry for the players mentioned above. The CMA should also recognise the extent to which new entrants or regulated firms using different business models that do not involve 'accepting deposits' – even those charging fees – may in fact reduce the overall cost, or increase the overall benefit, associated with PCAs, BCAs and other business finance services, as mentioned above. The BSA Manifesto for Mutuals, for example, highlights how mutually owned finance institutions face limits on capital raising and the ability to lend to small businesses, for example. Retail lenders on P2P lending platforms face punitive distortions in their effective personal tax rates because they cannot offset bad debt and fees against interest earned from funding consumer loans for personal income tax purposes, whereas banks and other finance businesses can deduct their own losses and other costs. This particularly inhibits P2P finance for low income earners to compete with unauthorised overdrafts, store cards or payday loans, for example. Credit unions need support with access to payments infrastructure. All new entrants face a fundamental competitive barrier to entry into the PCA, BCA and business finance markets in terms of banks' comparative sales and marketing might. Terms of access to the payment system are notoriously opaque, as the owners of that system are the incumbent banks. Groups such as Tusmor and Positive Money have highlighted such concerns.

The CMA must also investigate the impact of the ownership and governance structures of the various payment systems as a major potential barrier to entry for new banks and other payment service providers, as well as control over technical standards that supports low levels of investment by incumbents and otherwise prevents innovation and competition. The proposals in PSD2 for centralised and institutional control over technical standards and security measures; and requiring exempt technology service providers to supply their services via financial institutions rather than SMEs and consumers are also of real concern in this context.

Conclusion

The issues raised by your investigation into the banking market are fundamental to the UK's society and economy. If, however, your work is restricted to looking at traditional retail bank models, then we do not believe the underlying issues of competition and market failure will be addressed. Only by embracing the potential for a far more diverse marketplace can consumers and businesses expect better outcomes.

Further Information

Further information on the Finance Innovation Lab can be found on the website.

Detailed queries on this submission can be sent to:

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