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TSB Bank plc

Response to the Updated Issues Statement

Introduction

1. TSB welcomes the opportunity to comment on the CMA's updated statement of issues in the retail banking market investigation (the 'UIS') published on 21 May 2015. As explained in its submissions during the CMA's investigation to date, TSB believes that competition does not work effectively in these markets and action is necessary to remedy the current situation.

2. This response is structured as follows: first, TSB provides a brief recap of the key competition problems in the PCA and SME banking markets from TSB's perspective; and secondly, TSB comments on the UIS, focusing on the three theories of harm. TSB recognises that some of the comments set out in this response might be relevant to possible remedies, but offers them on the basis that the CMA may be interested in these observations at this stage, as they also inform the assessment of the competition problems.

3. TSB notes that the UIS covers both PCA and SME banking and that the same theories of harm are identified for both markets. TSB provides both PCAs and SME banking services but has a much more significant presence in PCAs than in SME banking. In this response TSB focuses on PCAs but, in general, TSB believes that the same or very similar competition problems arise in SME banking, particularly with regard to the smallest customer firms which exhibit similar traits to retail customers.

4. In summary, TSB broadly agrees that the issues identified in the UIS are relevant, and with the CMA's current thinking in relation to the theories of harm that it has identified. TSB considers that these problems are interlinked and any solution must be comprehensive in order to address all of them (not least to avoid making the market worse).

5. Moreover, as set out in this response, there are some issues where TSB considers that the CMA should have greater focus in its investigation going forward. TSB may supplement this response in due course as relevant working papers are published by the CMA.

Competition problems

6. As stated in its response to the CMA's statement of issues published on 12 November 2014, TSB believes that competition in the UK retail banking market is hindered by two factors, even with the entry of some new providers in recent years: first, customer inertia results in low levels of switching relative to reported levels of customer (dis)satisfaction; and, secondly, and partly as a result of the first problem, incumbent banks enjoy scale and incumbency advantages which act as barriers to entry and expansion. This results in most

customer flow being acquired by a small group of large incumbent banks (see further below).

7. The combined result of these factors is that new entrants and smaller competitors cannot grow to the size they would need to reach in order to provide effective competition to incumbent banks. Addressing one of these factors in isolation, without also addressing the other, is not only unlikely to have a positive impact on the market, but could exacerbate the current problems and lead to still worse outcomes from consumers.

8. Simply increasing switching, without also addressing the structural barriers which prevent new entrants and smaller competitors from competing effectively with incumbents for PCA customers, is likely further to increase the strength of established incumbents, and would at best allow for incremental evolution in the market, rather than genuine competitive disruption from new providers resulting in improved consumer outcomes.

9. TSB continues to believe that, by further investigating the theories of harm set out in the UIS, the CMA will have the opportunity to investigate the key competition problems outlined above. TSB therefore supports the approach outlined in the UIS.

Theory of harm 1 – Impediments to customers' ability to shop around, choose and switch

10. TSB agrees with the CMA's current thinking that low switching rates may be indicative of a market that is not functioning well. Moreover, when considering impediments to switching, it is important for the CMA to be cognisant of the fact that switchers and individuals who are new to banking account for only a small proportion of the total stock of PCAs, and that most of this customer "flow" is acquired by the major incumbent banks – resulting in conditions where it is very difficult for a challenger bank to grow to a scale where it can be a genuinely disruptive competitive force.

11. Indeed, CACI PCA market flow data shows that the number of new accounts opened for each of the months from July 2014 to February 2015 was materially lower than the equivalent month in the preceding year, whilst data published by the Payments Council indicates that, in Q3 2014, 84% of switchers using CASS switched to one of the five largest high street banks (Barclays, HSBC, LBG, RBSG, Santander). These trends indicate that it is more important than ever for the CMA to address the competition problems it has identified to date.

12. In light of this, TSB supports the CMA's proposal to gather further evidence in relation to the issues set out at paragraph 91 of the UIS, in particular the areas identified below.

13. TSB notes that the CMA proposes to gather further evidence on whether there are impediments, perceived or actual, to switching for overdraft users.[1] TSB agrees this is an important issue on which the CMA should obtain further evidence. In that regard, TSB sets out at <u>Confidential Annex 1</u> to this response additional data relating to the propensity of its

[1] UIS, paragraph 91(e).

customers who use overdrafts to switch PCA providers. That data shows that those TSB customers categorised as "always"[2] in overdraft represented just [redacted] of switchers out from TSB, but made up [redacted] of TSB's active PCA base. This suggests that this category of customers (ie those customers that most heavily use an overdraft facility) are unable or unwilling to switch. TSB believes this could be as a result of concerns that the overdraft facility will not be matched by a new provider or because overdraft costs are not easy to compare. If this is replicated across the market, the result is that competition in the provision of overdrafts (which would result in better rates and other terms for customers) is inhibited.

14. The data set out at <u>Confidential Annex 1</u> also demonstrates that a large proportion of those customers categorised by TSB as "always" in overdraft – [redacted] – fall within the top decile of its customers based on profitability; and a further [redacted] of those customers fall within the second to top profitability decile. This means that, of TSB's most profitable 20% of customers, approximately [redacted] percentage points – or [redacted] of these customers – are in the "always" in overdraft category. The data therefore supports TSB's submission that higher value customers have a lower propensity to switch PCA providers.[3]

15. TSB also agrees with the CMA's proposal to gather further evidence on whether incumbent banks have advantages related to customer acquisition costs driven by low engagement and switching, brand loyalty, cross-selling and tying/bundling and ability to spend more on marketing and advertising.[4] As TSB has previously stated to the CMA, in order to be an effective competitor to the incumbent banks, a challenger bank needs to be sufficiently financially resilient for it to be able to cover the significant costs of customer acquisition and retention, and also the high fixed costs associated with operating a retail bank in the UK, including the significant regulatory, IT, and other "back office" costs (where incumbents typically enjoy significant economies of scale and which, of themselves, can act as a barrier to entry and expansion – see further below). A challenger also needs to engage in significant marketing and advertising spend.

16. In the light of its experience in building and launching a stand-alone multi-channel bank, TSB believes that, without sufficient scale, no challenger bank would be able to invest the sums needed to be an effective competitor in the centre ground of the market.[5]

17. In relation to the impact of CASS on switching rates, TSB considers that there is significant room for improving CASS. Attached at <u>Confidential Annex 2</u> is a TSB paper which considers the limitations with CASS and the improvements that could be made to it (with particular reference to the possible impact of full account number portability on switching rates).

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2 Analysis of this 'always' group has shown that these overdrafts are predominantly 'planned', ie a borrowing facility up to a set limit agreed in advance.

3 As recorded at paragraph 60 *et seq* of the CMA's TSB case study published on 21 May 2015.

4 UIS, paragraph 91(d).

5 TSB, CMA Case Study Submission, 22 December 2014, Section D(d).

18. As further set out in that discussion paper, TSB considers there to be a number of important limitations with CASS as it currently operates, including: loss of the customer's transaction history; reluctance to switch resulting from concerns over continuation of overdraft facilities; lack of customer awareness; and the fact that it is an all or nothing system – ie it does not cater for partial switchers (those customers who want to open a PCA with a new bank, without closing their old PCA). The discussion paper identifies a number of ways in which CASS could be improved in order to mitigate these limitations, for example through the centralisation or sharing of customer data.

19. For the reasons set out in the discussion paper, and based on a cost/benefit analysis, TSB believes that full account number portability alone is not the solution to these issues; it would be costly and complex to implement and would still not address all of these limitations – and therefore it may not lead to significantly increased levels of switching. That said, TSB recognises that some customers would be more likely to switch as a result of full account number portability, and therefore considers that it could play a role in improving switching as part of a wider package of measures (eg as part of the introduction of broader banking infrastructure intended to reduce barriers to entry and growth).

20. TSB considers that, as part of its analysis of theory of harm 1, the CMA should seek to gather further evidence on the limitations with CASS and how those limitations could be addressed in order to increase switching rates.

Theory of harm 2 – Concentration giving rise to market power leading to worse outcomes

21. In relation to theory of harm 2, the CMA appears to suggest (as the second possible mechanism through which concentration may result in customer detriment) that, where it is difficult to discriminate between active/switching and inactive/non-switching customers, banks with higher market shares may have reduced *incentives* to lower prices and/or improve quality/innovation because they are content to earn greater profits from their existing customer base and accept a lower share of new customers – in other words, that the incumbent banks compete less vigorously for their own active customers, leading to worse outcomes for those customers.[6]

22. In TSB's view, it will be important for the CMA to bear in mind that, even if this theory of harm is borne out, the larger banks still have the *ability* to compete more aggressively over a longer period than challengers for all active customers, as a direct result of their size. This is because, with a large inert customer base, they are more easily able to spread the significant costs of customer acquisition and also the high fixed costs base (as explained above).

23. TSB therefore considers that the issue of concentration is closely linked to the advantages enjoyed by incumbent banks in relation to customer acquisition costs, to which the CMA

6 UIS, paragraph 99(b).

refers in the context of theory of harm 1. TSB agrees with the CMA's proposal to gather further evidence on this issue.[7]

Theory of harm 3 – Barriers to entry and expansion

24. TSB strongly agrees with the CMA's current thinking that as a result of the existing barriers to entry and expansion any new entry in the future is likely to be only relatively small scale and/or targeted at particular market segments. TSB also strongly agrees that high costs of customer acquisition may impede entry and expansion on a scale sufficient to stimulate effective competition and constrain the incumbent banks.[8]

25. The series of six case studies published by the CMA clearly demonstrate the range of barriers that present particular obstacles for challengers and new entrants. For any bank aiming to provide a full service multi-channel distribution model for PCA products in direct competition to the large incumbents, rather than operate a niche business model, these barriers are particularly acute. TSB welcomes the CMA's decision to publish further working papers on barriers to entry and expansion, and anticipates providing additional comments in response to those papers.

26. With specific reference to IT systems, TSB notes that the CMA's current thinking is that the availability of off-the-shelf and third party hosting solutions has reduced IT costs for new entrants significantly.[9] As the CMA is aware from the evidence provided by TSB, TSB considers that IT costs are a significant barrier to entry and expansion, especially for challengers who aim to provide a full service multi-channel offering. Indeed, it may be because of these significant and prohibitive costs that TSB is alone in being a full-service multi-channel bank, whereas other recent entrants have focused their proposition around a single channel or product. TSB is therefore especially interested to see the CMA's working paper on barriers to entry and expansion: regulation, IT systems and payments systems.

27. As previously explained to the CMA, TSB's experience of relying on another bank for IT and systems services is that it places some constraints on the user's ability to implement changes to support product development and the evolution of its business more generally. TSB suggests that, in the context of IT infrastructure, the CMA considers the impact of IT infrastructure on a bank's ability to innovate as a barrier to entry and expansion, as well as the cost of the IT infrastructure.

28. In any event, TSB considers that IT costs remain a significant barrier to entry and expansion, notwithstanding the availability of off-the-shelf and third party hosting solutions. This is especially the case given that, in TSB's experience, no one IT provider is able to provide a comprehensive IT solution with all of the functionality that would be required by a full service multi-channel bank. Moreover, TSB believes that, although it may be possible for a

7 UIS, paragraph 91(b).
8 UIS, paragraphs 158 and 159.
9 UIS, paragraph 159.

challenger to obtain IT solutions that, whilst not performing as well as 'big bank' IT, are adequate for a small scale operation, those solutions cease to be adequate as the challenger expands beyond a particular scale. For these purposes scale is not the number of PCAs *per se*, but the number of transactions (particularly payments) per second. With that in mind, TSB has been developing its thinking as to whether a central "banking utility" would significantly reduce that barrier to entry and expansion. A copy of a TSB discussion paper on this issue is attached at Confidential Annex 3. Based on TSB's initial thinking, although there would be a number of challenges associated with a central utility, such a central utility could address the barriers to entry and expansion associated with IT costs.[10]

29. In addition, TSB considers that it is important for the CMA to bear in mind that, whilst IT infrastructure is a significant fixed cost for any challenger bank, it is far from the only fixed cost associated with operating a retail bank in the UK. Others include costs associated with compliance, regulatory and legal functions, and reporting teams, which need to be a certain minimum size regardless of a bank's scale. These costs are proportionately greater for a challenger bank than the larger incumbent banks and therefore can act as barriers to entry and expansion.

30. In relation to access to payments systems, TSB agrees with the CMA's current thinking that access to payment systems may amount to a barrier to entry and expansion, and welcomes the CMA's statement that it will liaise closely with the Payment Systems Regulator on this issue.

Conclusion

31. In response to the statement of issues, TSB stated its opinion that the three theories of harm need to be seen as complementary aspects of a single competition problem. TSB continues to believe that is the case.

32. Theory of harm 1 and theory of harm 3 identify barriers that protect incumbents and prevent new entrants from effectively challenging incumbents. The combined effect of those theories of harm is to create the market structure identified under theory of harm 2, in which incumbents enjoy relatively stable market shares, face limited peripheral competition from smaller players, and have little incentive to compete vigorously with each other; while the effect of theory of harm 2 further reinforces and intensifies the effects of the other theories of harm.

[10] As the CMA is aware, Sabadell has indicated in its offer for TSB that it estimates that it can deliver efficiency cost savings in IT amounting to approximately £160 million per annum on a pre-tax basis, in the third full year after completion of the offer, and that these expected savings derive from a full migration of the IT transitional services currently provided by Lloyds Banking Group onto Sabadell's proprietary technology platform (see email of 27 May 2015 from [redacted] of TSB to [redacted] of the CMA). Nevertheless, the issues identified in the attached paper remain relevant for TSB and other challengers and entrants into the market more broadly.

33. This lack of effective competition, either between incumbents or from challengers, leads to adverse outcomes for consumers. Both sets of barriers (those identified under theory of harm 1 and those identified under theory of harm 3) are important and need to be addressed. Removing one without removing the other could inadvertently re-enforce the advantages which incumbent banks enjoy.

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