Competition and Markets Authority (CMA): Retail banking market investigation Updated issues statement – Virgin Money response

Summary

Theory of harm 1

- **Consumer engagement with the PCA market is weak, as the CMA notes**
- **As a result, switching levels remain low, despite the introduction of CASS**
- **We believe these are both symptoms of an underlying problem which is the structure of the PCA market and, in particular, free-if-in-credit banking**

Theory of harm 2

- **The incumbent banks, given their large market share, have a rational, collective interest in maintaining the status quo**
- **We believe that better outcomes for consumers are more likely to come from challenger banks and/or new entrants than from the large incumbent banks**

Theory of harm 3

- **We agree with the CMA that barriers to entry have been reduced, thereby facilitating increased entry into the PCA market**
- **However, as the CMA notes, subsequent expansion beyond small-scale and/or targeted entry has been limited**
- **We believe that, with free-if-in-credit banking, it is extremely difficult, if not impossible, for challenger banks and new entrants to achieve sufficient scale and income to justify full-scale entry into this market**

Virgin Money has entered the PCA market with the launch of a basic bank account and aspires to establish a broader and growing presence in the PCA market

1. Virgin Money has launched a basic bank account, intended to be the first in a range of PCA products. We aspire to expand our presence in this market over time and believe that increasing our market share in PCAs would complement our strong and growing presence in the mortgage, savings and credit card markets. We believe our leading consumer brand should make us ideally placed to achieve this. However, we believe that this will only be possible if and when regulatory and market conditions allow it.

2. As a medium-sized challenger bank looking to expand our presence in PCAs and more generally in retail banking, we supported the Competition and Market Authority's (CMA) decision to make a Market Investigation Reference (MIR) with respect to the PCA market. This is because we believe that competition is weak in the PCA market and that further fundamental reforms will be necessary to stimulate greater diversity of provision, competition and innovation in PCAs, and deliver better outcomes for consumers.

3. We welcome the opportunity to comment on the CMA's Updated issues statement which summarises the CMA's current thinking based on the evidence received and the analysis undertaken to date, and structured around its three theories of harm, namely:

    - theory of harm 1: customer behaviour and banks' response;
    - theory of harm 2: concentration giving rise to market power; and
    - theory of harm 3: barriers to entry and expansion.

4. We believe that these three theories of harm set out in paragraph 46 of the updated issues statement, provide a good framework for the CMA investigation, and we agree with the CMA that they are inter-related.

5. Our response begins with consideration of theory of harm 3 which, given its focus on barriers to entry and expansion, is of most interest to Virgin Money. Also, we believe that for consumers better outcomes are more likely to come from challenger banks and new entrants than from the large incumbents. We then look at theory of harm 1 and 2 respectively. Finally, we consider matters not covered in the updated issues statement, including account number portability (ANP).

There has been significant new entry into the PCA market over the last five years but, as the CMA notes, subsequent expansion beyond small-scale and/or targeted entry has been limited

6. As the CMA notes in paragraph 115 of the updated issues statement paper under theory of harm 3, "there has been significant new entry in the provision of PCA's in the UK in the last five years". We welcome this new entry into the market which in part reflects the concerted efforts of policymakers and regulators to address some important barriers to entry.

7. For example, the measures taken by the regulatory authorities to streamline and simplify the authorisation process are to be welcomed. We agree with the CMA in paragraph 119 that the authorisation process for becoming a bank is now "proportionate and efficient".

8. Furthermore we agree with the CMA's assessment in paragraphs 120-122 that the relatively high capital requirements previously imposed on smaller banks and new entrants are being reduced. The PRA has already taken a more flexible approach to new entrants' Pillar 2B capital planning buffers, and has abolished arbitrary capital add-ons. Additionally, a more level playing field between capital requirements under the standardised approach and the IRB approach is being established through the PRA's new approach to pillar 2A capital requirements for credit risk and through the Basel Committee's planned introduction of capital floors.

9. We believe that access to payment systems, necessary to support entry into the PCA market, still presents a complex challenge for new entrants and smaller banks. However, we have welcomed the establishment of the new Payment Systems Regulator (PSR) and believe it has the potential to reduce both barriers and entry costs. In particular, we welcome the PSR's intention to conduct a market review of indirect access to payment systems, which will also examine technical access solutions.

10. Under theory of harm 3, the CMA in paragraph 118 differentiates between entry and expansion in the PCA market. It states that "there are a number of different strategies available to potential entrants", before going on to make the crucial observation that:

> *Such strategies suggest that entry and subsequent expansion beyond small-scale and/or targeted entry is limited. Excluding TSB, the combined anticipated PCA market share by 2020 of all the relevant banks including prospective new entrants in our case studies is less than approximately 8%.*
>
> *The cost of IT systems and/or the need for a branch network have been key factors in the relevant banks adopting strategies that appear to limit the scale of entry and future expansion. Customer acquisition costs whether arising from weak customer response or other factors are also an important factor in limiting the scale of expansion following entry. Theory of harm 1 focuses on these issues.*

11. Virgin Money's own analysis and experience leads us to believe that, under current circumstances, and even with a leading consumer brand and after a successful targeted entry into the basic bank account market, it is extremely difficult to achieve sufficient volume and profit to justify full-scale entry into the PCA market. We made this point in our response to the CMA's December 2014 case study request:

> *The primary reason for our decision not to invest materially to grow market share of current accounts is the fact that the current oligopoly of incumbent banks which control the current account market benefit from the continuation of barriers to entry which makes it impossible for a new competitor to enter the market at scale or cost effectively*

12. We therefore agree with the CMA's findings, as set out in paragraph 118, that although barriers to entry have been reduced and whilst a number of firms have been able to establish a foothold successfully in the PCA market, important barriers to expansion remain (including the cost of IT systems) and weak customer engagement (reflected in low levels of switching), and still need to be addressed.

13. Under present circumstances, and in the absence of growth through business acquisition, we believe it will be extremely challenging for new entrants in the PCA market to expand sufficiently to gain significant market share.

14. The CMA cites the need for a branch network and the cost of IT systems as factors that may have hindered expansion in PCAs.

15. With respect to the need for a large branch network, whilst the CMA is correct that a branch network appear to be important for a significant proportion of customers, we believe that this sector characteristic is of declining importance for many retail banking products. This is due to the growing popularity of alternative distribution and money management channels such as online and mobile banking.

16. We believe that the salience of the branch network for consumers will continue to decline over time and that it is important that the FCA recognises these changing consumer preferences, takes a positive view of developments in online and mobile banking and gives firms clear guidance on how online and mobile bank account opening processes should comply with anti-money laundering regulations.

17. As the CMA has recognised, significant investments in IT systems (including building linkages with payment systems) are necessary to support full-scale entry to the PCA market. This we believe may constitute a more important barrier to entry and expansion than the need for an extensive branch network.

18. We believe that the most important factor limiting the ability of new entrants and smaller banks to the PCA market to expand and grow scale is lack of confidence that they can achieve sufficient volume and income to generate a return on this investment within a reasonable period, given the current structure of the market. Volumes are constrained by low levels of switching and income is constrained by the free-if-in-credit banking model. We consider low switching and free-if-in-credit banking in greater detail below.

Consumer inertia in the PCA market and low switching are in part results of the dominance of the free-if-in-credit model of PCA provision

19. We believe the underlying reasons why Virgin Money and other challenger banks/new entrants face problems in growing volume and income is captured by the CMA's first theory of harm. This theory of harm is based upon the hypothesis that difficulties in searching and switching make it difficult for new entrants and smaller banks to gain market share, resulting in weak incentives for banks to compete for customers on the basis of price, quality and/or innovation. We concur and believe these factors help explain why new entrants find it so difficult to grow to scale in the PCA market.

20. We supported the introduction of CASS. The recent FCA report *Making current account switching easier*, however, noted that "switching volumes have increased [since the introduction of CASS] but continue to remain low".[1] We agree with the CMA that it is important to understand why the introduction of CASS does not appear to have had a greater impact.

21. We agree with the CMA's analysis that large numbers of consumers are not currently engaging with the PCA market and that this is reflected in low switching levels. This consumer inertia is in marked contrast to consumer behaviour in many other parts of the retail banking market (particularly credit cards, which also offer payment and borrowing facilities), suggesting that the causes of this inertia lie in factors unique to the PCA market, in particular the free-if-in-credit model of PCA provision which as the CMA notes in paragraph 67 remains the most common form of PCA tariff in the UK.

22. We discuss other factors which contribute to this inertia – such as the opacity of pricing structures, as well as the need for a more reliable switching process – later in our response. But we believe that further measures in these areas, whilst helpful, will prove insufficient to address consumer inertia and create a more dynamic market, unless the fundamental problems that stem from the free-if-in-credit banking model and the resultant incentive structures for both firms and consumers are not addressed at the same time.

23. We understand why free-if-in-credit PCA provision remains popular with many customers and with consumer groups. Many consumers have benefited through not having to pay for their PCA.

24. This model of PCA provision 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, or who forego credit interest. We believe that such cross-subsidies distort the market**.** They also lead to charges for customers who are less affluent or well-informed.

25. However, we recognise that, if PCA charges were to be introduced in a way that reduced the cross-subsidies and that did not increase banks' overall income from PCAs, the move away from 'free' banking would probably still be unpopular with certain groups.

26. We believe that the free-if-in-credit characteristic of the PCA market is an important explanation of why competition does not work well in the PCA market. The combination of the lack of a headline price for PCAs, along with the opacity and complexity of charges for additional account features, such as insufficient fund charges and overdraft authorisation charges, means that, unlike in most markets, prices and price changes do not drive competition in this particular

[1] The CMA in the Updated issues statement paper has estimated the switching level for CASS to be around 2% of all UK main accounts for the year ending February 2015

market. The end result is that the economic incentives for many consumers to switch are deficient or absent in the PCA market.

27. The incentives to switch may have been further eroded in the current low interest rate environment, with base rate at 0.5% and most PCAs offering low or zero credit interest. The incentives to switch may increase as base rates rises, but we do not believe this will make a fundamental difference to customer inertia in the PCA market.

28. John Fingleton, former head of the OFT has spoken about how competition should be driven by transparent, up-front pricing:

    Our view at OFT was that explicit, transparent pricing should be on the things where the banks make all their money; forgone interest and overdraft charges were the least transparent and least visible to the customer-put aside quite enormous distributional effects as well, which they had across different income categories. Our preferred solution would have been to try to stem all of the alternative sources of revenue and channel competition into up-front charges

29. Similar points have been expressed by the Deputy Governor of the bank of England, Andrew Bailey:

    I think that the pricing of retail banking is a problem in this respect. The notion of free banking has in my view distorted the landscape. There is of course no such thing as free banking. What it really stands for is that charges are levied inconsistently across products supplied by banks, with the consequence that some appear to be free. It also leads to what in my view are unhelpful and damaging decisions on the supply of products. The philosophy should be, give the public what they want but at a fair price which is transparent to them

30. Paragraph 68 of the updated issues statement posits the view that free-if-in-credit "is harmful because it increases customer inertia by reducing customers' perceptions of the value of different PCAs and/or softens incentives on banks to compete". We agree with this statement and would argue that a direct link exists between the consumer inertia that the CMA correctly identifies as a key characteristic of the PCA market, the complex pricing structures, opacity and lack of headline pricing which are inherent features of the free-if-in-credit banking model, and low levels of switching.

31. The consequence, as we articulated earlier in this response as well as in previous submissions to the Treasury Committee, Independent Commission on Banking (ICB) and the Parliamentary Commission on Banking Standards (PCBS) is that it is extremely difficult, if not impossible, at present for firms such as Virgin Money to achieve sufficient scale and income to ensure a rate of return (including on the necessary investments in IT systems) which would justify full-scale entry into the PCA market.

32. Furthermore, as the CMA acknowledges in paragraph 126 in the barriers to entry and expansion section of the paper under Theory of harm 3:

The inability of new entrants to attract sufficient volumes of customer deposit, due to low levels of switching, means that they are likely to be constrained in their ability to expand their banking (or lending) business.

33. In *Competition and choice in retail banking,* The Treasury Committee observed that barriers to entry and expansion in PCAs (which they viewed as a 'gateway product'), limited the potential growth of challenger banks/new entrants in other retail banking products.

34. The CMA has said that it intends to do further work on the underlying reasons for the lack of customer engagement in PCAs. We believe that this lack of engagement stems directly from the free-if-in-credit model, which should be a central focus of any analysis in this area, and we therefore welcome the CMA's intention of "undertaking a range of analyses to assess the effect of free-if-in-credit banking on competition".

35. We encourage the CMA, as part of this analysis, to consider both the problems associated with free-if-in-credit banking which we have outlined above, and also to examine the difficulties and barriers in moving away from this form of provision – including the possibility of negative consumer reaction and the risks of perceived collusion. Andrew Bailey has commented on some aspects of this:

It is hard for a single bank to break out of the existing situation without appearing to raise the price of its services to customers (even though it may not actually be raising the price as a whole). And, it is hard for the industry as a whole to break out without appearing to collude. So it may require intervention in the public interest, not least because it is a way to encourage greater competition.

The advantages of the large incumbent banks may well operate against better outcomes for consumers through greater competition and innovation

36. The large incumbent banks dominate the PCA market and payment systems, and as a result, continue to dominate other parts of the retail banking. In paragraph 99 under theory of harm 2 – concentration – the CMA poses the question as to "whether banks with higher market shares may have weaker incentives to lower prices or improve quality/innovation than a bank with a smaller market share". We have sympathy with this view and believe this is an area which the CMA should explore further.

37. Given the market concentration in PCAs, as recognised in theory of harm 2, we believe that the large incumbent banks have a rational, collective interest in maintaining the status quo. This is because:

- It allows them to maintain long-term customer relationships through PCAs, and opportunities to cross-sell other retail financial products to their PCA customers;
- It provides them with significant amounts of low-cost sticky funding; and
- It perpetuates barriers to entry and, perhaps most importantly, to expansion.

38. In response to the question raised by the CMA in paragraph 99, we believe that the large incumbent banks have limited incentives to compete on price or to innovate:

    - with respect to prices: the income gains to the large incumbent banks from lowering prices would be uncertain and be unlikely to offset the income losses from the reduction in price for existing customers;
    - with respect to innovation: the large incumbent banks may have an anti-innovation bias in some areas, believing that innovation could open up entry to challenger banks and other new entrants. Certainly the development of Faster Payments and Mobile Payments took far longer than could have been the case.

39. We understand the practical difficulties associated with the allocation of costs and capital has led the CMA to decide “not to undertake the market-wide profitability analysis as originally proposed”. However, the absence of a financial analysis makes it difficult to assess whether the large incumbent banks are making ‘excess profits’ on PCAs, or whether they are using PCAs as a ‘loss leader’ to cross-sell other products, and in so doing perpetuating barriers to expansion in retail banking.

40. We note the comment in paragraph 29 that PCAs “are profitable when considered separately for the banks’ overall retail banking propositions”. We understand that this comment is based on financial data provided by the banks, not the CMA’s own economic analysis. We think that it would be helpful if the CMA were able to disclose this analysis, including the assumptions made by the banks about the allocation of costs and capital.

A switching process which commands the confidence of consumers is also necessary to create a more competitive PCA market

41. A key driver of effective competition is creating the conditions where consumers have choice and incentives to switch, but also crucially on their ability to exercise choice. The ability for consumers to switch easily and with confidence in the reliability of the switching service is therefore an important element of a competitive market.

42. We supported the introduction of CASS. However, as we noted previously in this submission, the recent FCA report concluded that switching levels continue to remain low. We believe the underlying reasons for the failure of CASS to significantly increase switching levels falls into 2 categories:

- consumer inertia for the reasons outlined through the course of this submission; and
- continued lack of confidence in the switching process, as demonstrated by the fact that consumer confidence in CASS remains below the Treasury's target of 75% of consumers confident by June 2015.

43. We continue to believe that serious 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 the CMA identified in the original Issues Statement, through for example enabling fairer and more open access to key payment systems, as well as creating a more effective, quicker and more reliable switching service.

44. This could be achieved by creating a central portal which would hold bank account numbers at customer level (not by banking institution) – much like national insurance or mobile phone numbers. Each centrally-held account number would control a customer's transactional process, with banking providers linking their products to the central service.

45. ANP would create a much easier, faster and more reliable switching service. However, importantly it would also significantly reduce the barriers to entry and expansion for smaller banks associated with the very considerable IT requirements necessary to enter the PCA market. It would also reduce reliance on the agency banking model.

46. There could also be financial stability benefits associated with a move to portability which should be explored further. The ability to switch customer funds easily and centrally to a "safe haven" could help mitigate the risk of bank runs and ensure customers gain quick access to deposits in the event of bank failure.

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