Non confidential version

CMA Retail Banking Market Investigation
Response to the Updated Statement of Issues
dated 21 May 2015

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1 Introduction and Summary

This submission sets out the views of The Royal Bank of Scotland Group plc ("**RBS**" or "**the Bank**") in response to the Updated Issues Statement published by the Competition and Markets Authority ("**CMA**") dated 21 May 2015 (the "**UIS**") as part of its market investigation into the supply of personal current accounts ("**PCAs**") and of banking services to small and medium-sized enterprises ("**SMEs**") (the "**Market Investigation**").

Following a summary of the main issues arising in this response, Section 2 of this document provides a brief summary of RBS's response to the CMA's Statement of Issues submitted on 5 December 2014 (the "**IS Response**"); in Section 3, RBS's comments in relation to the UIS are set out, covering general comments (in Section 3.1) and comments in relation to each of the CMA's theories of harm (Section 3.2).

1.1 Focus on demand-side issues

RBS welcomes the CMA's continuing focus on demand-side concerns as well as the CMA's recognition of the inter-relationship between the three theories of harm ("**TOH**").[1] RBS views this inter-relationship and the core role of demand-side concerns in this regard as the kernel of the issue: to the extent that the large number of banking choices are not reflected in low concentration levels, and to the extent that challengers face expansion barriers, demand-side inertia is critical to these supply-side assessments. As noted by Martin Wheatley of the FCA in a recent speech: "*if you want an increase in numbers on the pitch to translate into an effective increase in competition, there must be demand-side reform. Consumers must have the power to discipline the market*".[2]

The findings of the CMA in the UIS together with the working papers published to date suggest that, on closer inspection, many of the barriers to entry and expansion within retail banking are already being addressed by other regulators such as the PRA (e.g. reviewing the capital requirements applicable to smaller banks), the FCA (e.g. reviewing authorisation requirements and pre-application support for new entrants) and the PSR (most notably its review of access to payment systems, including in relation to indirect participants). That said, RBS considers that there may still be room to refine rules to make them more proportionate and/or more harmonised such as in relation to anti-money laundering rules for account openings.

1.2 Need for robust analysis

RBS notes the importance of a robust and up-to-date empirical analysis underpinning the investigation's findings. Yet in a number of important areas at this stage in the investigation, the UIS points to a relatively cursory study of issues that would be core to a stand-alone analysis of TOH2 or TOH3. If the resulting findings were used to shape the outcome of the investigation, this may be a cause for concern. In particular, RBS would highlight two areas where this is most relevant:

- *Geographic market definition*: as already flagged in its IS Response,[3] and as explained further below, RBS is concerned that there is inadequate evidentiary foundation for the CMA's proposed approach to geographic market definition. The

[1] UIS at paragraph 48.

[2] Speech by Martin Wheatley, CEO of the Financial Conduct Authority, delivered at the Future of Financial Services event in London on 2 June 2015 available at: http://www.fca.org.uk/news/firms/regulation-supporting-vibrant-markets.

[3] See section 3.1 of the IS Response submitted to the CMA on 5 December 2014.

political boundaries of the UK's nations may or may not form economic boundaries for the purposes of the SSNIP test set out in CMA guidance,[4] but this coincidence cannot be presumed: markets can be anything from local to UK-wide. Indeed, this important question appears to have attracted little empirical scrutiny (e.g. via customer survey evidence).[5] As noted before, these issues are considerably less acute when applied to the CMA's TOH1 because, whether the market is UK-wide (as seems appropriate for TOH1) or segmented, RBS doubts that customer inertia varies significantly across political boundaries within the UK. As such, the ultimate conclusions in relation to TOH1 are less likely to be susceptible to change than if inadequately defined markets underpin conclusions on market concentration (TOH2) or entry (TOH3); and

- *Profitability*: RBS sympathises with the CMA's acceptance of the challenges in undertaking a robust analysis of market-wide profitability.[6] However, the alternative approaches proposed will face the same challenges that the CMA has identified in its original profitability analysis. Simple comparisons are prone to misleading results and limit the evidence base upon which conclusions can be drawn.

RBS would also urge the CMA to ensure that its analysis is forward-looking and takes full account of recent and ongoing initiatives affecting the industry. These include developments both within the banking industry as a whole (such as the "branch in a box", CASS and the increasing uptake by customers of internet and mobile banking) as well as initiatives driven by government/regulators (e.g. midata and the "Banking for the 21st Century" government programme). In order to optimise the outcome for banking customers, it is important that the cumulative impact of these multiple moving parts is considered as a whole.

It will not necessarily be easy to measure the likely long-term impact of some developments, as they have only recently launched. However, in order to avoid over-regulation and/or unintended consequences that might undermine recent developments, it is important to avoid focusing exclusively on that which is easily measurable and take these recent developments (and their anticipated impact over the medium to long term) into account.

1.3 Customer satisfaction

The GfK survey commissioned by the CMA finds a high level of customer satisfaction with PCAs: 91% of customers are either "very satisfied" or "fairly satisfied" with their main current account provider and there are similar levels of satisfaction when particular aspects of a current account are considered.[7] However, the CMA refers to Net Promoter Score ("**NPS**") as a "measurement of satisfaction"[8] and indicates an intention to draw inferences about overall levels of customer satisfaction based on the market-wide average NPS of 6%.[9] As previously explained to the CMA, NPS is *not* a measure of satisfaction, but instead captures customer evangelism or advocacy, and so drawing conclusions about satisfaction based on NPS is not appropriate. A number of factors drive NPS, in particular,

4 Guidelines for Market Investigations (April 2013) (CC3 Revised) at paragraphs 137-141.

5 UIS at paragraph 24(c).

6 UIS at paragraphs 25-30.

7 UIS at paragraph 58.

8 UIS at paragraph 59.

9 UIS at paragraph 59.

reputational issues, that mean that satisfaction levels may diverge significantly from NPS data. Further, the creators of NPS explicitly caution that the relative positioning of NPS of individual firms is more insightful than their level, calling into question the relevance of any comparison drawn based on the banking industry's market-wide NPS.[10]

1.4 Working papers

Finally, RBS understands that the CMA aims to publish working papers ("**WPs**") containing its detailed analysis on a number of issues by mid-July and may publish a small number of additional papers prior to provisional findings (scheduled for September).[11] RBS has concerns that, in some areas, it is difficult to understand fully the reasoning behind a particular position in the UIS without the benefit of seeing the CMA's underlying thinking as set out in WPs. Accepting the CMA's intensive workload, RBS would encourage the CMA to expedite publication of the WPs in order to facilitate a full exchange of views at the parties' hearings. RBS will supplement the present response, as appropriate, as the CMA publishes additional WPs.

2 Summary of RBS's Response to the Issues Statement dated 5 December 2014

In its IS Response, RBS explained its new strategic direction, centred on transparency, improved customer service, product rationalisation and simplified products and pricing.[12] RBS considers that this strategy recognises and, for its part, seeks to address many of the market-wide issues identified by the CMA, in particular, those under TOH1. RBS has provided evidence of the numerous initiatives it has undertaken with the objective of implementing this strategy and becoming "number one" for customer service, trust and advocacy by 2020.[13] This strategic drive should be viewed in the context of a changing environment which includes the introduction of CASS, the midata initiative, the launch of the Gocompare website and Business Banking Insight.

The Bank suggested that the CMA particularly focus on demand-side issues (TOH1) because concentration and any barriers to entry and expansion (TOH2 and TOH3) should be regarded primarily as derivative of these demand-side issues, rather than as stand-alone problems. RBS recognised that its unilateral efforts to make its offer fairer, simpler and more transparent – while working with the grain of the CMA's customer-focused agenda – cannot improve the functioning of the entire market. That said, at an industry level, initiatives such as CASS and midata are also taking root, even if it is too early to fully gauge their impact.

RBS therefore welcomes the opportunity to engage further with the CMA on possible enhancements to these and other initiatives to spur levels of customer engagement and their ability to exercise informed choice.

[10] For example, Bain Consulting, "Linking Loyalty and Growth" available at: http://www.bain.com/publications/articles/linking-loyalty-and-growth.aspx.

[11] UIS at paragraph 3.

[12] See section 2 of the IS Response submitted to the CMA on 5 December 2014.

[13] [**confidential**]

3 Response to Updated Issues Statement dated 21 May 2015

3.1 General comments

3.1.1 Market definition

(i) Product market

(a) PCAs

In the UIS, the CMA indicates that it does not intend to widen the market for personal customers beyond PCAs because none of the alternative products are able fully to substitute for all the features of a PCA and, therefore, do not exercise a sufficient constraint on PCAs so as to be considered part of the same market.[14]

RBS agrees with the CMA that, given their wide functionality, PCAs should be considered as part of a PCA-wide market. RBS further agrees with the position that products such as instant access savings accounts and digital wallets do act as substitutes for certain features of the PCA and that their competitive constraint must be factored into the CMA's analysis.[15] As explained in previous submissions, alternative providers such as PayPal and Amazon also represent a significant and rapidly evolving competitive threat to RBS and other larger players.[16] Moreover, the FCA has observed that the UK (together with Ireland) is "*today the fastest growing FinTech incubator in the world, developing at an annualised rate of some 74% since 2008*".[17] A recent report published by Accenture revealed that investment in FinTech in the UK and Ireland rose 136% year-on-year to USD 623 million in 2014.[18] Given the scope for innovation from these "technology entrants", this competitive threat is seen within RBS as potentially stronger than other more traditional PCA providers (particularly given the potential for cherry-picking specific parts of the value chain). The impact of innovation is increasingly extending into the SME space through the impact of PayPal, FX transactions and other innovations (see further below).[19]

RBS would appreciate more clarity on how the CMA intends to take into account the significant and evolving competitive constraint posed by these existing and potential competitors. RBS considers this particularly relevant given the importance of the CMA conducting a forward-looking market investigation rather than limiting itself to an examination of the status quo.

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[14] UIS at paragraph 24(a).

[15] See RBS's response to question 22 of the PCA Market Questionnaire submitted to the CMA on 23 January 2015.

[16] See section 3.3.2 of the IS Response submitted to the CMA on 5 December 2014 and RBS's response to questions 5 and 22 of the PCA Market Questionnaire submitted to the CMA on 23 January 2015.

[17] Speech by Martin Wheatley, CEO of the Financial Conduct Authority, delivered at the Future of Financial Services event in London on 2 June 2015 available at: http://www.fca.org.uk/news/firms/regulation-supporting-vibrant-markets.

[18] Approximately GBP 400 million. Accenture report 2015, "The Future of Fintech and Banking: Digitally disrupted or reimagined?", available at: http://www.fintechinnovationlablondon.net/media/730274/Accenture-The-Future-of-Fintech-and-Banking-digitallydisrupted-or-reima-.pdf.

[19] See, for example, "Debit Card V me digital wallet proposal Jan 2014" at slides 2 and 3, submitted to the CMA on 25 November 2014 (document reference: 4.1.10.2.2.1.2).

See also "UK banks need to work harder on profitability, study finds", published by the Financial Times on 7 April 2015, available at: http://www.ft.com/cms/s/0/2dca53ac-dd1c-11e4-a772-00144feab7de.html?ftcamp=published_links/rss/companies_banks/feed//product#axzz3WczpkzY7.

(b) SME banking

RBS agrees that, as a general proposition, BCAs and SME loans belong to separate product markets.[20] However, RBS considers that SME loan products should not be segmented by: (i) general purpose business loans; and (ii) other types of loan. Instead these belong to a single wider market.

In particular, RBS would argue strongly in favour of including alternative finance products (e.g. asset and invoice finance and peer-to-peer lending) as part of an overall market for SME loan products. RBS experiences constant competition from alternative finance providers, particularly asset and invoice finance providers, in competing to provide financing for SMEs. As an illustration, SME Finance Monitor calculates the use of "other" forms of finance as 16% (this includes asset and invoice finance although not trade credit and internal finance that also act as potential alternatives to bank lending).[21]

While peer-to-peer lending is still at a relatively early stage as compared to asset and invoice finance, there is no doubt that it represents a competitive constraint on traditional banks and this is set to increase in the future with growth of 160% in this market segment in 2014.[22] It is estimated that alternative funding could account for up to £12.3 billion worth of business lending per year in the medium term and the number of new entrants would suggest that this trend is set to continue.[23] The competition represented by peer-to-peer and crowdfunding platforms will undoubtedly be reinforced by numerous government initiatives (the new Deeds of Priority protocol, the publication of lending data at postcode level, etc.) as they seek to enable new platforms "*to compete with traditional lenders on fairer terms, raise funding more efficiently, and, alongside other alternative finance providers, access potential SME borrowers and the information held on them by the big banks to lend to them more effectively*".[24] Similarly, and as mentioned above, FinTech payment firms in the SME space are exerting a significant competitive constraint on RBS and larger banks in other ways through, for example, SME payments using PayPal and expanding choice in relation to foreign exchange transactions. RBS expects this competitive constraint to grow in light of the government's initiatives aimed at providing FinTech companies access to the payment systems on fairer and more transparent terms.

The anticipated government reforms to remove barriers to expansion in this space and to establish referral portals for SME credit applicants whose applications for funding are declined (or who decline the terms on which their bank offers funding) can be expected to stimulate further growth. In March 2015, HM Treasury said that eight further peer-to-peer platforms were to be launched imminently[25] (in addition to 20 new banks which are in the

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20 UIS at paragraph 24(b).

21 SME Finance Monitor, Q1 2015, p.2.

22 Appendix B of UIS, paragraph 18. See also speech by Martin Wheatley, CEO of the Financial Conduct Authority, delivered at the Future of Financial Services event in London on 2 June 2015, available at: http://www.fca.org.uk/news/firms/regulation-supporting-vibrant-markets noting that the UK's alternative finance market has been close to doubling in size year on year and provided close to £2 billion of funding since last year alone.

23 See section 3.3.2 of the IS Response submitted to the CMA on 5 December 2014 and RBS's response to question 53 of the SME Market Questionnaire submitted to the CMA on 28 January 2015. [**confidential**] See also: Nesta Report, "Banking on each other: peer-to-peer lending to business: evidence from Funding Circle" (http://www.nesta.org.uk/publications/banking-each-other-rise-peer-peer-lending-businesses) and "Banking without banks" – The Economist – 1 March 2014 (http://www.economist.com/news/finance-and-economics/21597932-offering-both-borrowers-and-lenders-better-deal-websites-put-two).

24 "Banking for the 21st Century: driving competition and choice" – March 2015, on p.7 (https://www.gov.uk/government/publications/banking-for-the-21st-century-driving-competition-and-choice).

25 "Banking for the 21st Century: driving competition and choice" – March 2015, on p.5 (https://www.gov.uk/government/publications/banking-for-the-21st-century-driving-competition-and-choice).

process of obtaining FCA approval to launch in the UK). RBS is also aware that there are many bidders in place for designated portal status and that these portals will promote themselves to SMEs as the primary route to acquiring finance rather than waiting to be declined by their primary bank. RBS expects that over time SMEs will visit the portals directly before, or indeed instead of, approaching their bank.

(ii) Geographic market

(a) Reliance on previous investigations

Given TOH2 and TOH3, RBS is concerned that the CMA does not appear to be intending to undertake a rigorous economic analysis of geographic market definition, but will instead rely on previous (and now dated) findings that separate markets exist for England & Wales, Scotland and Northern Ireland.[26] RBS would encourage the CMA to undertake a fresh examination of market definition to the extent that this will be central to the CMA's TOH2 or TOH3. The importance of accurate market definition increases as greater weight is placed on concentration as a useful lens to inform substantive and remedial thinking. Market concentration indicia such as market shares and HHI used in an MIR carry a promise that they relate to a properly-defined relevant market; otherwise they are simply "shares of supply".

Prior reports are now significantly out of date, particularly given the level of change in retail banking markets in recent years. Nor is it clear that they examined issues of geographic market definition in any depth at the time. The only relevant Phase II inquiry (i.e. the Competition Commission (the "**CC**") 2002 SME banking investigation) did not, in its report or annexes, provide any detailed analysis or empirical support for choosing political boundaries as economic ones. As is only to be expected, the CC did not apply economic techniques with the contemporary rigour of the most recent market investigations in retail markets, notably *Groceries* and *Private Healthcare*[27] and, even if this had occurred, an update would be necessary given the passage of time, including the financial crisis.

RBS is also concerned that the CMA appears to be proposing to adopt a more fragmented approach in relation to PCAs than has previously been adopted. In the 2008 PCA market study and its 2013 update, the OFT considered geographic markets of (i) Great Britain, and (ii) Northern Ireland. In 2010, the OFT focused on the review of barriers to entry, expansion and exit in retail banking only, and did not seek to define a market for PCAs. While the 2014 update to the PCA study drew upon data for Great Britain, UK, England & Wales and Scotland, the question of geographic market was not dealt with in any depth.[28]

(b) Current market features show that separate national markets are not appropriate

As the CMA indicates, recent changes suggest that today there is a wider market which should be viewed, at its narrowest, as (i) Great Britain and (ii) Northern Ireland.[29]

26 UIS at paragraph 24(c).

27 See, in particular, paragraphs 2.53 and 2.55 of the CC's 2002 SME banking Report. The geographic chain of substitution argument in favour of a separate Scottish market is susceptible to various criticisms (see, for example, the CC critique of Tesco's arguments in the *Groceries* Investigation (see Groceries report at paragraph 4.117)).

28 The Cruickshank Report (2000) focused on market shares for Great Britain as a whole, even though some local characteristics of consumer behaviour were noted and the Parliamentary Commission on Banking Standards' report (2013) did not go any narrower than the UK.

29 UIS at paragraph 24(c).

First, banks have adopted an approach to products and services across the UK that is undifferentiated as to geography or the boundaries of the UK's nations, suggesting that they themselves do not make any distinction between Scottish customers and those in England & Wales. RBS itself (excluding Ulster Bank at present) generally applies a harmonised policy across the UK, does not make any distinction in product development/design across regions and does not routinely segment customers by region. Moreover, within the Bank, regions do not constitute a feature of governance arrangements. Instead, they are pan-GB and soon to encompass Ulster Bank as well.

Secondly, a dynamic assessment of retail banking providers in Scotland increasingly mirrors that in the rest of the UK. For example, Santander, Nationwide and Handelsbanken have all recently increased their Scottish customer base. It is noteworthy, that none of these providers has considered it necessary to adopt or retain Scotland-specific branding. In particular, the CMA will be aware that many of Nationwide's Scotland branches were acquired through its 2009 acquisition of Dunfermline Building Society[30] and rather than keeping this traditional Scottish brand (which would be consistent with "stickiness" to domestic brands), Nationwide spent money in the *opposite* direction, undertaking a rebranding exercise to bring all its branches under the (English) Nationwide brand.[31] Similarly, Santander has not differentiated in any way its branding between Scotland and England & Wales.

Lastly, it is also of note that none of the prospective entrants cited in the CMA's case study has identified geographic coverage as a concern. This is particularly important in relation to OakNorth and CivilisedBank, both entering the SME banking space.[32]

Accordingly, RBS considers that the markets for retail banking, both for PCAs and SME banking, are properly considered to be at least GB-wide plus Northern Ireland and would encourage the CMA to avoid simply assuming for market definition a coincidence between the dynamics of the Scottish population as *citizens* in the *political* arena, and as *consumers* in the *economic* arena. RBS does not, in any event, consider that a separate Welsh market for either PCAs or the provision of banking services to SMEs is at all appropriate. Such an assessment has no basis in either precedent or in how retail banking in Wales operates. However, as noted, it follows from the above that it would be inappropriate for the CMA, for the sake of argument, to discount the submission of the Welsh government for a separate Welsh market as being inspired by wider non-economic considerations rather than empirically grounded in the evidence, while at the same time adhering to an approach to Scotland and/or Northern Ireland that is not empirically grounded in economic evidence.

3.1.2 Profitability

RBS welcomes the CMA's acceptance of the challenges in undertaking a robust analysis of market-wide profitability.[33] However, RBS notes that the alternative approaches proposed by the CMA will face the same challenges that the CMA has identified in its original profitability analysis. Simple comparisons are prone to misleading results and limit the evidence base upon which conclusions can be drawn. RBS suggests the CMA shares a methodology paper for comment by the Interested Parties before advancing its

30 Completed acquisition by Nationwide Building Society of parts of Dunfermline Building Society, OFT ME/4108/09.

31 "More than 1m Cheshire, Derbyshire and Dunfermline customers will see branches become Nationwide - or shut" (http://www.thisismoney.co.uk/money/saving/article-2320825/45-building-society-branches-shut-Nationwide-rebrand.html).

32 See "Retail banking market investigation: Prospective entrants", 5 June 2015 at p. 7.

33 UIS at paragraphs 25-30.

profitability WP, to provide an opportunity for them to assist the CMA in delivering the robust piece of analysis that is required.

At Group level, it is well known that RBS has for some time been unprofitable (and the levels of SME profitability in the Cruickshank era thought sufficient to merit remedies are long gone).[34] However, within PCAs and SME banking there are profitable segments,[35] and both PCAs and SME banking make commercial sense on a stand-alone basis. Neither is cross-subsidised, although there are certain customer segments which represent investment in the pipeline of future potentially valuable customers (e.g. start-ups in the SME space and youth/student accounts in the PCA space). Additionally, RBS's Basic Accounts [**confidential**] relate to the fulfilment of an important social function (one discharged exclusively by larger banks).[36]

Furthermore, any perceived increase in overall low profitability does not appear to act as a disincentive for newer entrants to launch and expand in the UK. Their model is usually to cherry-pick the most profitable customer segments or products and they are not encumbered by legacy costs, including the continual "refreshment" of (historic) branch networks, the cost of payment systems, holding a back-book, dated IT systems, capital and ring-fencing obligations or reputational damage arising from the financial crisis.[37] Some challengers have placed less focus on the free-if-in-credit ("**FIIC**") vanilla PCA space[38] in particular, given that the two main income streams identified by the CMA have dissipated: interest foregone is very low in a low interest environment and overdrafts have been reduced.[39]

3.1.3 Pricing

The initial finding from the PCA user-profile pricing analysis is that there is no systematic difference in prices charged by larger or smaller banking providers. This is consistent with RBS's experience: RBS competes with both larger and smaller banks.

The CMA also identifies "*wide variation in prices across the banks*".[40] Pricing variations require a careful assessment before any conclusions can be drawn. For example, some of the variation is likely to be driven by banks tailoring their accounts and pricing schedules to some extent to the requirements of the consumers that they attract. In other words, there is likely to be some variation in the profiles of customer between different PCA providers. This also means that some of the user profiles which the CMA has designed are more relevant to certain PCA providers than other PCA providers. The tailoring of accounts to meet customer needs is a natural aspect of healthy competition between PCA providers, and also explains the price variation the CMA observes within each PCA provider.

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34 See sections 2.1 and 3.2.3 of the IS Response submitted to the CMA on 5 December 2014. [**confidential**]

35 [**confidential**]

36 See further RBS's response to question 20 of the Second Financial Questionnaire submitted to the CMA on 2 April 2015.

37 See section 3.3.1 of the IS Response submitted to the CMA on 5 December 2014 and RBS's response to question 5 of the PCA Market Questionnaire submitted to the CMA on 23 January 2015. See also speech by Martin Wheatley, CEO of the Financial Conduct Authority, delivered at the Future of Financial Services event in London on 2 June 2015, available at: http://www.fca.org.uk/news/firms/regulation-supporting-vibrant-markets, discussing the importance of entrants such as M&S, Post Office and Tesco as retail banking competitors without legacy issues.

38 Although RBS notes that, in the case studies, some challengers, particularly Virgin Money, cite the FIIC model as a disincentive to switch (i.e. no reduced driver to switch given perception that banking is "free" anyway) – this aligns with RBS's view that FIIC does distort the market and makes it harder for customers to compare rival offerings.

39 See also below at Section 3.2.2.

40 UIS at paragraph 103.

The CMA has yet to publish initial findings from their BCA user-profile analysis. SME customers are a diverse customer group and designing representative user profiles is a particularly difficult challenge. It is disappointing that the CMA has not taken on board RBS's suggestion of including start-up profiles, which represent an important segment of the market.

RBS welcomes the CMA's acceptance that quality (especially of service) is an important variable and so needs to be accounted for.[41] This is supported by the GfK survey commissioned by the CMA, in which customers identified quality of staff and customer service as the most important aspects of their main current account. RBS notes that some challengers (although by no means all) have adopted strategies that deliberately avoid some of the more costly service aspects offered by the larger banks, in particular, by steering away from complex omni-channel distribution systems[42] and developing products aimed at only the most profitable customers.

The CMA's initial observations on PCA and BCA net revenues[43] are in line with RBS's experience. For example, revenues from unarranged overdrafts have fallen since 2011 [**confidential**] in absolute and relative terms and the PCA business model is underpinned by the use of PCA credit balances as funding for other banking products.

3.1.4 Innovation

RBS agrees with the CMA's view that there are many examples of healthy innovation in the retail banking sector in the UK.[44] Many of the more obvious (although still significant) examples of innovation have to date occurred within the PCA space (e.g. Contactless, Digital Wallets, and the increasing number of "reward" style or interest paying accounts).[45] In addition, RBS has very recently confirmed its involvement in Apple Pay, an initiative expected to go live in July, which will allow Apple Watch, iPhone 6 and iPhone 6 Plus users to make payments for goods and services with their iPhones in stores using a contactless chip. Apple Pay also lets users make Touch ID purchases within apps that have adopted the Apple Pay API. Devices capable of using Apple Pay within iOS apps include the iPhone 6, the iPhone 6 Plus, the iPad Air 2 and the iPad mini 3. Apple Pay will help RBS accelerate its broader electronic payments capability across both MasterCard credit and Visa Debit.

Innovation has also been evident in SME banking as a whole as illustrated by a number of regulatory and government initiatives as well as bank-specific innovations and FinTech innovations. Regulatory and government initiatives include:

- legislating for cheque imaging, which will allow firms to offer customers innovative ways of paying in cheques, for instance, via their smartphones (this will benefit PCA customers as well as SMEs);
- launching a major programme of work on digital currencies;

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41 UIS at paragraph 104.

42 See KPMG "The game changers – Challenger Banking Results" May 2015 (https://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Market%20Sector/Financial%20Services/challenger-banking-report.pdf), p.15 noting that "*current challengers do not offer a better mobile banking experience than the big high street banks. Functionality is generally the same, if not worse, than that offered by the bigger lenders*".

43 UIS at paragraphs 35-36.

44 UIS at paragraphs 41-43.

45 UIS at paragraph 44.

- the EU agreement to cap anti-competitive credit card interchange fees, potentially saving UK businesses and consumers up to £480 million per year; and
- initiatives relating to access to transparency noted below at Section 3.2.2(ii)(b).

Similarly, as the CMA indicates, there are significant ongoing developments in SME lending at the core product level – including asset and invoice finance, and peer-to-peer lending – which are fundamentally reshaping the financing options available to SMEs and expanding the scope of the lending market.[46] While it is true that this represents a fairly modest proportion of the market at present, the growth rates and significant new entry indicate that this will be an increasingly important source of competition for the more traditional banks in the short to medium term.[47] New credit risk assessment models (such as those offered by Fidor) may also be expected to reduce SME lending costs/risks.

A number of current RBS initiatives are also directed specifically at SME banking, including:

- RBS launched its iPhone banking app in January 2012, targeting business and commercial customers as well as retail customers. The app was intended to provide easier access to banking for customers, with better features to allow customers to view statements and balances, to do account to account transfers and to locate ATMs and branches near them.[48]
- RBS adopted "Paym", a service which allows money to be sent using the payee's mobile phone number rather than their account number and sort code. This service is available to personal customers as well as SMEs.
- [**confidential**]

3.2 Theories of harm

3.2.1 General comments

RBS agrees with the CMA's view that the three TOH identified are fundamentally inter-linked.[49] More specifically, RBS considers that demand-side issues go to the heart of competition issues in the retail banking sector. Tackling those demand-side issues will not only address the customer engagement concerns set out in the CMA's TOH1, but would also address any concerns around concentration and barriers to entry and expansion (TOH2 and TOH3), which RBS views as derivative of TOH1.

3.2.2 TOH1: Core demand-side issues

The CMA is considering whether customers' ability to choose effectively and switch products and suppliers has been impeded and whether this results in weak incentives for

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46 UIS at paragraph 44.

47 The CMA suggests that awareness and interest in alternative finance among SMEs is low (UIS at paragraph 44). This is based on survey research that 56% of SMEs are unfamiliar with any form of alternative finance and 60% are unlikely or very unlikely to begin/continue using an alternative finance platform in the near future. The fact that 44% of SMEs are familiar with at least one form of alternative finance does not suggest awareness is low; indeed, the survey authors (University of Cambridge and Nesta) conclude: "*many SMEs are familiar with alternative finance platforms but few have approached them*". Furthermore, the most common reason cited for not using an alternative finance platform by SMEs aware of such platforms was not a preference for more traditional financing nor any concerns about using an alternative finance platform, but instead: "*not needing external finance*" (77%). Source: Nesta (2014), *Understanding Alternative Finance* (http://www.nesta.org.uk/blog/understanding-alternative-finance).

48 **[confidential]**

49 UIS at paragraph 48.

banks to compete. By way of general comment, RBS agrees with the CMA's proposed framework for assessment, namely considering customer engagement and then looking at the "access, assess, act" factors.[50]

As the CMA notes, there are clearly differences between PCAs and SME banking products,[51] but, equally, there is a certain level of common ground between the two, particularly for smaller SMEs.

(i) PCA

(a) Customer engagement

RBS submits that, notwithstanding the puncturing of the myth of large-scale customer dissatisfaction by the CMA's empirical work, customer engagement across both PCAs and SME banking can be improved.[52] As the CMA notes, a greater understanding of the lack of customer engagement and fuller consideration of how best to address it are important aspects of the ongoing Market Investigation. RBS contends that the enhancement of customer engagement could lead to a greater propensity to switch and that many of the recent initiatives described in this and RBS's previous submissions can be expected to drive up engagement (and so switching volumes).

However, as the CMA explains, low engagement is not a problem per se.[53] In particular, if customers are benefiting from good outcomes, there is less need for increased engagement with alternative products. Indeed GfK data suggest that 51% of customers have not looked around/switched because they are "happy with current supplier" and a *Which?* Survey reports 67% of non-switchers as being happy with their bank.[54]

RBS notes that customer satisfaction levels in both PCAs and SME banking are in fact considerably higher[55] than some external commentators appear to think. This would appear also to have been reflected in the CMA's own survey results. This confirmation of how customers consider their bank is surely a key factor in explaining apparently low switching levels. Comparisons with switching levels in other industries (such as mobile phone or motor insurance providers) are inappropriate given the different relationship (and needs) customers have with their banks compared to these other types of provider.

The CMA also notes that other measures of satisfaction may be taken into account, including, for example, NPS.[56] The CMA refers to the average NPS for PCAs as being 6%, and then states that it is "*considering how best to draw inferences about overall levels of customer satisfaction and how these vary between providers*".[57] [**confidential**][58] NPS is not a measure of satisfaction, but instead captures customer advocacy.[59] While this may

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[50] UIS at paragraph 52.

[51] UIS at paragraph 55.

[52] UIS at paragraphs 57 and 79.

[53] UIS at paragraph 58.

[54] *Which?* Consumer satisfaction survey dated March 2014.

[55] Grant Thornton UK LLP has found that 91% of customers report satisfaction or better with their bank ("The customer experience of modern-day banking" available at: http://www.grant-thornton.co.uk/Global/The_Customer_Experience_of_Modern_Day_Banking.pdf).

[**confidential**]

[56] UIS at paragraph 59.

[57] UIS at paragraph 59.

[58] [**confidential**]

[59] Reichheld, F.F. (2003), "The One Number You Need to Grow", December, pp.5-6, and Satmetrix Systems (2004), "The Power Behind a Single Number", White Paper, pp.3-4.

be related to satisfaction to some degree, the two are in fact quite different.[60] NPS has a much stronger connection to actual customer behaviour and growth (i.e. the likelihood of "promotion" to new customers) than satisfaction on its own.[61]

RBS would welcome the opportunity to further engage with the CMA on how to consider customer satisfaction most appropriately and on the role of other measures of customer loyalty or engagement, such as NPS in this investigation. In this regard, RBS would highlight the disparity between NPS for the RBS and NatWest brands despite the fact that the two brands offer the same products, use the same processes and methods of delivery.[62]

Further, RBS would caution against using the market-wide level of NPS to draw conclusions about the banking industry, since the creators of NPS explicitly state that NPS should be considered relative to some benchmark and not in isolation. In particular, the relative positioning of the NPS of individual firms is more insightful than their level.[63]

(b) Access

The CMA notes that customers generally have access to the information they need, but that complexity and comparability of information varies across account features.[64] As explained in its previous submissions, RBS's ongoing initiatives seek to provide more transparency and simplicity in the information it provides to customers.[65] For example:

- RBS no longer offers different rates to PCA (and SME) customers who apply online, in branch or by telephoning a call centre. Pricing is consistent, regardless of channel, across the RBS, NatWest and Ulster Bank brands;
- RBS and NatWest customer letters and emails are being simplified for personal customers so they are straightforward and transparent. The number of pages on the personal banking website has been reduced from [**confidential**] to [**confidential**], with language simplified;
- [**confidential**]
- [**confidential**]
- RBS is continuing to move PCA customers from off-sale products to on-sale products, meaning that an increasing number of existing customers have the same products as new customers.

RBS is addressing pricing as part of its overall simplification and transparency programme. A number of recent RBS initiatives have aimed at achieving this overall objective of

60 See, for example, the differences in correlation with customer behaviour for survey measures of recommendation, loyalty and satisfaction in Figure 2 in Satmetrix Systems (2004), "The Power Behind a Single Number", White Paper, p.4.

61 Reichheld, F.F. (2003), "The One Number You Need to Grow", December, p.3.

62 See section 3.2.4 of the IS Response submitted to the CMA on 5 December 2014.

63 Reichheld, F.F. (2003), "The One Number You Need to Grow", December, pp.6-7; and Bain Consulting, "Linking Loyalty and Growth", last accessed 22 January 2015 (http://www.bain.com/publications/articles/linking-loyalty-and-growth.aspx).

64 UIS at paragraph 63(a).

65 See section 3.2.2 of the IS Response submitted to the CMA on 5 December 2014. [**confidential**]

simplification, including the end of teaser rates and all new customer offerings being made available to existing customers.[66]

Of course, RBS acknowledges that its own actions, while reducing complexity for RBS customers, cannot transform the ability of customers to compare products across different banks. Therefore, RBS would welcome engagement with the CMA to explore existing and proposed industry initiatives that might improve the ability of customers to compare different products by different bank brands. In this regard, the government's midata initiative is a very promising starting point and RBS expects that midata will substantially increase the ability of consumers to make informed choices about PCAs by comparing across products.

In addition to midata, there are a substantial number of other initiatives that are likely to improve transparency in the PCA market and which should be taken into account by the CMA as part of its forward looking view, in particular:

- the development of an open Application Programing Interface ("**API**") standard under the "Banking for the 21st Century" initiative which is expected to further increase consumer engagement by facilitating for consumers the identification of the best deals. The API is likely to improve on the midata approach by being more user-friendly, taking into account a wider range of data, and being more customisable; and
- increased digital banking, which will enhance the accessibility of relevant products and facilitate increased transparency through easier access to relevant information, including pricing information; and
- the EU Payment Accounts Directive, specifically its provisions relating to the creation of common terms for fees and charges.

(c) Assess

RBS agrees with the CMA that it is important to understand whether there are behavioural biases which might limit customers' ability to accurately assess alternative offers and further agrees that this is closely linked to issues of complexity and comparability.[67]

As stated previously, RBS considers that FIIC does distort customer perceptions of the cost of banking and welcomes the CMA's intention to undertake further analysis to assess the impact of the model.[68] Put simply, the perceived (if not also actual) gains from switching in relation to a "free" product would surely never be as high, all else being equal, as for a product that customers perceive more vividly has a cost attached to it, and must therefore be "paid for".

RBS has previously noted that any end to FIIC would need to be co-ordinated by a central body such as the CMA. The first mover disadvantage in ending FIIC PCAs would be a very serious commercial risk to any bank. RBS notes that, in the case studies, the dampening effect of the FIIC model is also cited as a factor which suppresses switching by challenger banks.[69]

[66] See section 3.2.3 of the IS Response submitted on 5 December 2014. See also RBS's response to question 7 of the PCA Market Questionnaire submitted to the CMA on 23 January 2015. [**confidential**]

[67] UIS at paragraph 66.

[68] UIS at paragraph 69.

[69] See particularly Virgin Money case study at paragraphs 51-54.

(d) Barriers to switching

RBS agrees that switching levels can improve[70] and expects some of the recent initiatives described in this and its other responses to have a positive impact on switching levels. At the same time, it would resist:

- any "target culture" that would prescribe a certain switching level as optimal; and/or
- unhelpful comparisons with other retail industries, including those where customers do not value (advisory) relationships with suppliers.

A rigorous approach to the remedial question of improving switching levels must be accompanied by a proper diagnosis of what the current levels actually mean. The first issue is not "are switching levels low?" or "what is the right level of switching?" (there is no such "magic number"). Instead, the first question is: "what explains the current switching rate?". In response to this question, RBS highlights the existence of a number of factors that may go some way to explaining current switching levels, including at least the following:

- higher levels of customer satisfaction, reducing the incentive to switch;
- the impact of the FIIC model which reduces the incentive to switch by giving rise both to customer perception that there is little to gain from switching and to a lack of actual gain from switching (particularly in a very low interest environment); and
- the importance of multi-banking, which depresses the headline switching rate because it does not capture this form of switching behaviour.

Of course, as already noted, notwithstanding these points and the operational success of CASS, RBS also submits that switching rates would improve if customers could readily access and compare providers' offers to give them full confidence they are getting the best deal, or are switching to the best deal, for them.

No target switching rate

RBS believes that the burgeoning number of industry-wide and bank specific initiatives to encourage switching will increasingly incentivise customers to act where it would be advantageous for them to do so. Therefore, RBS would question the value of any attempt to propose to set a benchmark of what it would consider to be a "satisfactory" or "high" level of switching in the retail banking market. RBS would welcome further engagement on the levels of switching which the CMA would deem "competitive" in these markets – especially as UK switching levels seem in line with those in Europe[71] – and, in particular, considers it inappropriate to compare switching levels in retail banking to those in entirely different markets such as mobile phones, internet providers and car insurance due to the different relationship customers have with their bank (i.e. an advisory relationship) compared to these other service providers. As suggested above, RBS would be concerned if the CMA had implicitly sought to set a "target" for switching in retail banking based on switching levels in other dissimilar industries.

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[70] UIS at paragraphs 74, 82, 85, 88, 90.

[71] Appendix D to the UIS at paragraph 8.

Multi-banking effects

As to multi-banking, the statistics on switching do not take account of hidden switching. As well as customers that consider switching, but decide to remain with their existing provider, (which accounted for 16% of PCA customers in the last year, according to the GfK survey[72]) much switching is in value rather than volume terms, as dissatisfied customers look to rebalance away from their old bank without formally closing their account (multi-banking). RBS has observed an increase in multi-banking generally, particularly in the PCA market, with GfK's PCA survey indicating that 31% of PCA holders surveyed have PCAs with more than one bank, showing a significant increase from the equivalent figure in 2008, when only 18% of current account customers surveyed held accounts at two or more bank brands.[73] In disregarding this market feature, the CMA follows the example of previous market studies; this neglect was not justified at the time, and given the continued growth in multiple account holding, this would give rise to serious concerns if it were not addressed in the present Market Investigation.

The role of CASS

RBS also notes that the CMA has requested feedback on thoughts as to why CASS has not yet had a greater impact. RBS would note that CASS has had an important impact on switching in the market: according to April 2015 data, the service has so far processed more than 1.75 million switches.[74] The most recent figures show a 7% year-on-year increase in switching in the past 12 months (1 April 2014 to 31 March 2015) and a heightened awareness of customer switching (71% of the public are aware of the service).[75] Indeed, RBS and NatWest have experienced first-hand the impact of CASS: since the launch of the service, they have [**confidential**] personal customers between [**confidential**] and [**confidential**].[76] Ulster Bank [**confidential**] in the same period.[77]

As the CMA notes, the recent FCA review of CASS is useful in this regard, in particular, in relation to a lack of awareness in the service.[78] RBS is aware that CASS is in discussions with the FCA around plans to increase awareness of CASS via a number of potential initiatives, including greater promotion of CASS by firms in their own marketing and literature, and is also aware that CASS is investigating the potential of a central marketing campaign. RBS is fully participating in these discussions with CASS and actively examining further steps it can take in its own advertising and customer material to promote awareness of/confidence in CASS.

The GfK survey also suggests that perceptions about switching costs remain a potential barrier: 20% of respondents that had not switched or looked around in the last three years cited the hassle of switching as one of the reasons for not having done so, and a quarter of those who had looked around without switching gave this as a reason for not going ahead and switching.[79]

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72 GfK report "Personal Current Account Investigation: a report for the Competition and Markets Authority", April 2015 at paragraph 6.

73 See RBS's response to question 35 of the PCA Market Questionnaire submitted to the CMA on 23 January 2015.

74 See the Current Account Switch Service Dashboard 2015.

75 See the Current Account Switch Service Dashboard 2015.

76 [**confidential**]

77 [**confidential**]

78 UIS at paragraphs 73-74.

79 GfK report "Personal Current Account Investigation: a report for the Competition and Markets Authority", April 2015 at paragraph 10.

Importantly, the *actual* experience of the process among those who have switched is much more positive than the expectation. Of those who switched in the past year, 59% said they had expected the process to be easy, but 83% said they found it easy in practice.[80]

GfK reports that their qualitative research found that: "*for many consumers PCA services are seen as 'free' (particularly if you don't use an overdraft)*". [81] Therefore, the incentive for customers to look around is further reduced – why shop around for something that is free? Indeed, in many cases, the potential gains from switching will not be significant (this is particularly true in a low interest environment, but even with higher rates, average balances mean that many customers will not make significant gains from switching). However, there remains a segment of the market who will be tempted by better deals and RBS agrees with the CMA that more could be done to facilitate switching for those that wish to do so.

(ii) SME

(a) Engagement and search

RBS agrees that SME businesses do not exhibit strong engagement with their retail banking service providers and that this might in turn reduce switching levels below those expected were customers more engaged.[82]

However, as the CMA points out, "low" levels of engagement may be driven by broad customer satisfaction and in this regard it is particularly striking that more than half of SMEs rate their satisfaction as "excellent" or "very good" and more than 90% report satisfaction levels between "excellent" and "fair".[83]

As set out above [**confidential**],[84] NPS ratings are not a satisfaction rating, but rather (as noted in the SME section of the UIS) they are an advocacy rate. The CMA makes a factually incorrect statement that a negative NPS implies that "*a greater proportion of SMEs would discourage businesses from using their bank compared with those that would promote this*".[85] While individuals who respond to the "promotion" question of "*how likely is it that you would recommend [brand/product] to a relative, friend or colleague in the next 12 months?*" with 0-6 are referred to as "detractors", this does not mean that these individuals would actually discourage use of the brand or product in question. Rather, being labelled a "detractor" means that this customer is "less likely to recommend a company".[86] Hence, even though the NPS for SME banking products may be negative, this in no way implies the CMA's conclusion that more businesses would discourage rather than encourage others from using their bank for business banking. Therefore, RBS would urge the CMA to be very cautious of inferring "latent dissatisfaction" as a result of NPS in the face of compelling evidence that customers are, overall, satisfied with their SME banking services.[87]

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[80] GfK report "Personal Current Account Investigation: a report for the Competition and Markets Authority", April 2015 at paragraph 11.

[81] GfK report "Personal Current Account Investigation: a report for the Competition and Markets Authority", April 2015 at paragraph 12.

[82] UIS at paragraph 79.

[83] UIS at paragraph 79.

[84] [**confidential**]

[85] UIS at paragraph 80.

[86] Satmetrix Systems (2004), "The Power Behind a Single Number", White Paper, pp. 3-4.

[87] [**confidential**]

(b) Transparency and comparability of information

The CMA is concerned about the inability of SME customers to access and compare information about SME products. RBS would agree that it is more complex to compare SME products than PCA products, including for the reasons that the CMA identifies, in particular, difficulties in comparing different elements of a BCA package, negotiation of charges and lack of an effective comparison website.[88]

As with PCAs, RBS is taking significant steps to simplify its SME pricing structures and broader customer offering, including by reducing the number of SME products, introducing a calculator on the RBS and NatWest websites to enable prospective customers to receive a quote for loans, and developing fee support tools to make it easier for customers to understand charging structures.

As set out in its IS Response, RBS acknowledges that there is scope for extending these unilateral measures to improve transparency across the market as a whole. While there are a growing number of price comparison websites for SMEs, the current lack of any mechanism to run a comparison across different customers' service experiences is a significant gap in the growing variety of comparison websites. Similarly, the introduction of a degree of standardisation in the way that banking products are described and charged would certainly assist in comparisons between products.[89]

However, SME products may, for good reasons, be more bespoke and, therefore, less susceptible to easy comparison than PCAs. For example, negotiation of charges is likely to act in favour of a customer since negotiations will typically bring charges down from those advertised in headline rates. Similarly, the relationship and service components are typically more valued by SME customers and the particular service given to SMEs will be tailored to the particular needs of the business, which will be determined by its size, the sector in which it is active and the nature of the SME business.

As with PCAs, ongoing initiatives seeking to address issues of transparency and comparability in relation to SME banking include:

- Small Business, Enterprise and Employment Act 2015, which provides for the sharing of credit information on SMEs and can be expected to have a substantial impact on the ability of challenger banks and alternative finance providers to offer financing to SMEs;
- Business Banking Insight, which allows SMEs to rank providers based on their experiences and is expected to increase the ability of SME consumers to make informed choices for business banking;
- reform of Deeds of Priority/Waivers to increase the speed and efficiency of SME financing approvals which will reduce the costs to SMEs of switching lending provider;
- "Banking for the 21st Century", a government programme of initiatives, including changes to AML regulation, supporting the development of an open API standard, measures to make credit data available more widely through existing CRAs and a public tender to establish a number of portals to which larger banks will be obliged

[88] UIS at paragraphs 84(a)-(c).

[89] See section 3.2.2 of the IS Response submitted to the CMA on 5 December 2014.

to refer SMEs whose loan applications are declined or who decline their bank's offer of finance;

- "Innovation Hub", which is part of a wider "Project Innovate" developed by the FCA to foster competition and growth in financial services by supporting both small and large businesses that are developing products that could genuinely improve services for consumers. The Innovation Hub will provide businesses who qualify with access to a number of services, including: a dedicated contact for innovation-related queries, continuation of additional support for up to a year after authorisation, help to understand the regulatory framework and access to the FCA expertise to inform future policy development in a way that supports innovation; and
- expansion of CASS to include larger SMEs.[90]

(c) SME switching behaviour

As with PCAs, RBS expects higher levels of switching to come about and would caution against the use of any CMA benchmark for switching in retail banking. As noted above, RBS does not see comparisons with other retail products as particularly meaningful in this regard, and this is even more the case for SMEs than for PCAs. Once again, relationship and service capability are particularly pertinent here.

While firms, including RBS, have taken a number of steps to address AML and due diligence checks to simplify and quicken the account opening process (both in relation to SMEs and PCAs), it should be noted that there will be a limitation to how far they can go in light of existing regulatory/statutory requirements. RBS would observe that, if anything, there is a risk that these grow over time as the government of the day tries to deal with issues such as illegal immigration (see the new requirements to check whether customers are illegal immigrants when opening an account under the recent Immigration Act) and terrorist financing.

While the vast majority of customers are low risk from an AML standpoint, forms, data and evidence requirements are not uniform across banks. This may give customers the impression they are being taken through a different process by each bank. As set out in RBS's Undertakings in Lieu ("**UIL**") proposal, the Bank would support the CMA in encouraging the FCA to introduce measures to simplify and harmonise AML checks across the industry and so remove a potential disincentive for switching.[91]

Finally, in relation to CASS as it applies to SMEs, RBS would note that CASS has only very recently been expanded to cover larger SMEs, meaning CASS will now be open to 99% of UK SMEs. Therefore, it is unsurprising that awareness among businesses and charities would be lower than for personal customers, although, as mentioned above, RBS believes that, in light of the initiatives undertaken to date, awareness will improve, leading to higher switching levels.

(iii) Overall current thinking on TOH1

By way of summary of RBS's position on TOH1, the Bank agrees with the CMA that there are issues around customer engagement and the way that information is made available to

[90] Until March 2015, only small business accounts with an annual turnover and/or balance sheet not exceeding €2 million (or Sterling equivalent) and employing fewer than 10 people were eligible to CASS. See FCA report "Making current account switching easier", March 2015, available at: http://fca.org.uk/your-fca/documents/research/cass-report.

[91] See SME Banking Market Study, Joint UIL Proposal, Slide 11.

both PCA and SME customers. RBS considers that the CMA's TOH1 captures the root cause of its concerns with PCAs and SME banking. As a result of numerous industry-wide and bank-specific reforms and initiatives designed to reduce customer inertia, RBS considers that a good deal of the groundwork for enhanced customer engagement is in place. Whilst the CMA must consider the impact of these in the medium term, we believe that there remains scope to build on this work, and RBS would be happy to discuss further initiatives in the area with the CMA, potentially drawing upon previous work carried out in the UIL context.

3.2.3 TOH2: Concentration giving rise to market power and worse outcomes

RBS notes that the CMA intends to publish shortly a WP on its review of academic research into the relationship between concentration and outcomes.[92] RBS looks forward to reviewing the paper and will respond as appropriate at that time.

While the CMA acknowledges that the market shares of the four largest banks have been decreasing for PCAs since 2011[93] and for BCAs since 2012,[94] it also notes that concentration levels across PCAs and SME banking, although reduced, remain high. However, as also noted by the CMA, relatively high levels of concentration are not in and of themselves a problem, and even if a general relationship can be implied as between concentration and weaker competition, this is not sufficient.[95] Rather, in order to substantiate TOH2, the CMA needs to establish the means by which higher concentration may give rise to poorer outcomes for customers.

RBS sets out below its general comments on market shares and concentration levels, together with its preliminary views on the two mechanisms through which the CMA proposes to establish this required linkage.

(i) Market shares

In its UIS, the CMA notes that market shares for PCAs have remained relatively stable for both larger and smaller banks between 2011 and 2014, although the combined UK share of the four largest banks has decreased since 2011.[96] Indeed, recent figures show that RBS's shares of new PCAs dropped by [**confidential**] between [**confidential**] and [**confidential**] from [**confidential**] to [**confidential**] in the UK.[97] As regards SMEs, the CMA has observed broadly stable market shares, albeit with a small decline for the largest four banks of approximately 3% between 2012 and 2014 in BCAs.[98]

As stated in previous submissions,[99] while bearing in mind this downward trend in concentration, RBS accepts that the larger banks hold a large collective share of supply of the three main products at issue.[100]

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92 UIS at paragraph 94.

93 UIS at paragraph 18(c).

94 UIS at paragraph 21(d).

95 UIS at paragraph 95.

96 UIS at paragraphs 18(b)-(c).

97 [**confidential**]

98 UIS at paragraph 21(d).

99 See section 3.3 of the IS Response submitted to the CMA on 5 December 2014.

100 RBS was surprised by the statement in paragraph 14 of Annex 2 in Appendix B to the UIS that the asset finance market share of the four largest banks is more than 60% and would welcome the chance to review the data on which this is based. As the CMA notes, this data is based on a limited number of market participants (i.e. those who offer BCAs) and this must, of course, be taken into account when considering the weight to place on these market shares.

However, RBS invites the CMA to bear in mind its findings in relation to both TOH1 and TOH3 when assessing TOH2. As noted above in response to the CMA's TOH1, RBS maintains that high levels of concentration in retail banks are derivative of demand-side issues in the relevant markets. If the CMA successfully tackles these demand-side features, competition concerns arising from concentration levels should subside.

Likewise, in relation to TOH3, RBS draws the CMA's attention to the degree of new entry that it has identified in both PCAs and SME banking.

- In particular, the CMA draws attention to new entry in PCA banking in the last five years.[101] These new players include Metro, TSB and the planned entry of Williams & Glyn in the near future. In addition, a large number of banks present in ancillary financial services have also entered the PCA space, including Virgin Money, the Post Office, Tesco Bank and Handelsbanken. Prospective new entrants include Atom and Starling.
- In the SME space, healthy levels of entry and expansion are also clear. SME banks such as Aldermore, Shawbrook and Paragon have entered offering specialist products while, more generally, a wider variety of products have become available as a means of financing SMEs, including peer-to-peer lending, crowdfunding, asset finance, invoice finance and commercial mortgages.[102] Atom, OakNorth and Civilised Bank are all expected to enter the market shortly.

Growing customer awareness of challengers are reinforcing their impact on concentration levels. Recent surveys show that 29% of those questioned reported only looking at smaller banks. Through the combination of new entrants, alternative finance providers and the impact of CASS,[103] retail banking as a whole has gone through very significant changes in a short period of time, with a number of initiatives only recently launched and so yet to bed in.[104] This view is supported by the gradual decline in concentration highlighted by the CMA's own research and shared by other market players and one would expect the initiatives described previously only to accelerate this trend.

(ii) Limited correlation between "pure" concentration levels and market outcomes

The CMA correctly acknowledges that there is no automatic link between concentration and (adverse) market outcomes. Accordingly, it has put forward two hypotheses as to such a link.[105] As outlined below, RBS is not convinced that either mechanism will evidence adverse market outcomes.

(a) Connecting mechanism 1: *Ability of banks with higher market share to differentiate products and exercise market power*[106]

Under the first proposed mechanism, the CMA hypothesises that high levels of product differentiation limit the ability of customers to compare products and, accordingly, reduce

[101] UIS at paragraph 115.

[102] UIS at paragraphs 115-116.

[103] The Payments Council reported 1.16 million switches in 2014, a 12% year-on-year sustained increase from 1.03 million in 2013, with 69% of the public aware of the new service and 65% confident in how it works. [**confidential**] Competitors such as Santander, Halifax and Nationwide are being considered as the winners in the switcher market.

[104] Appendix B to the UIS, paragraph 11.

[105] UIS at paragraph 99.

[106] UIS at paragraph 99(a).

competition as between providers. RBS disputes this characterisation for a number of reasons.

First, there is a clear distinction between market shares, and share of wallet. RBS does not accept that high combined market share – which, as explained above, is diminishing – equates to share of wallet or gives rise to market power arising from concentration. It should not be forgotten in this context that there is ongoing political and regulatory pressure on larger banks to discharge a social function by supporting unprofitable (often financially vulnerable) and geographically remote customers. As a national, full service bank serving customers of all types and sizes, RBS engages with and supports these aims, but it is not a feature of most retail markets where suppliers are free to adapt and shed unprofitable customers.

Challengers are developing their market position by adopting niche strategies focusing on particular geographies, customers and products.[107] Although the CMA points to the lack of full-function entrants in its TOH3, this reflects precisely the bespoke and profitable strategy intended by challengers to cherry-pick the most profitable market segments or, in the case of the likes of PayPal, particular parts of the value chain.

Larger banks are also at a competitive disadvantage with regard to the costs of refurbishing and relocating legacy branch networks and IT platforms, as well as specific capital and ringfencing measures. RBS welcomes the CMA's observation that the inflexibility of existing IT platforms can be a competitive disadvantage for established banks,[108] and, as discussed further below in relation to TOH3, would note that similar issues relate to branch networks. [**confidential**]

All of these market features – the social role, cherry-picking strategies, branch network and IT systems – demonstrate that market shares do not equate to market power.

Secondly, product differentiation is generally pro-competitive – there has been material product innovation in recent years (e.g. the rise of reward or interest paying accounts in the PCA market over recent years). As the CMA correctly points out in its IS, a lack of choice as between products may be seen as an indication of an adverse effect on competition.[109] There is a risk that the CMA's analysis here becomes trapped in a double-bind, resulting in suppliers either being condemned for appearing too similar or, as is suggested here, too different. As far as similarity is concerned, RBS accepts that the "they are all the same" motif is part and parcel of TOH1 – notwithstanding suppliers' differentiation, consumers still find it hard to choose between banks, not only because the FIIC model genuinely removes price as a differentiator for standard PCAs, but because service levels are harder to compare than price points. As far as the theory that they are "too different" (i.e. market power arising from differentiation) is concerned, banks' efforts to differentiate, including RBS's fairness strategy, should be viewed as a pro-competitive initiatives to stand out and attract and retain customers despite any perception that may exist that "they are all the same".

[107] For example, Tesco Bank told the CMA that its strategy was to be the bank for Tesco customers where it rewarded their loyalty and earned their trust (Tesco Bank case study, paragraph 24) and Metro has chosen to focus on expanding in the South East around the London commuter belt (Tesco Bank case study, paragraph 21).

KPMG noted in its report that: "What almost all of the Smaller Challengers have in common is that they are niche players" ("The game changers – Challenger Banking Results", May 2015, at p.6, available at: https://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Market%20Sector/Financial%20Services/challenger-banking-report.pdf).

[108] UIS at paragraph 138.

[109] IS at paragraph 14.

As far as differentiation – not between suppliers or service levels but as to product portfolios per se – is concerned, RBS would, in this respect, agree that excessively long and complex product portfolios do not act in consumers' interests in helping them choose the best product, and for its own part RBS has undertaken extensive product rationalisation for this reason. This runs contrary to the CMA's reasoning of TOH2 as set out in the UIS, which would suggest that RBS should retain complex product portfolios in order better to exercise market power over its large customer base. RBS's actions in this respect, as outlined in detail in its IS Response, clearly contradict such a characterisation. It therefore seems somewhat perverse to draw upon a form of excessive differentiation as the base for a potential TOH.

Thirdly, as a general matter, this issue is more appropriately addressed under TOH1. RBS does acknowledge that there may be certain limitations on the comparability of products across providers. Indeed, as noted in its IS Response, an important aspect of RBS's strategic repositioning focuses on improvements to the transparency and accessibility of its PCA and SME banking products, which in turn are closely connected to and feed into the wider objective of improving trust and confidence in the Bank.

Accordingly, to the extent that less differentiation is to be encouraged (and, as the CMA has noted, this is not at all a given), this is an issue best considered in terms of how to design customer engagement discussed above.

***(b)* Connecting mechanism 2*: Difficulty in discriminating between active and inactive customers*[110]**

The second main mechanism that the CMA puts forward as a possible link between concentration and outcomes is the "*difficulty in discriminating between active and inactive customers*".

The CMA first notes the premise of "high levels of customer inertia" (in other words, TOH1). Under TOH2, it asks 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.

RBS would question the premise that banks are unable to discriminate between active/switching and inactive/non-switching customers in forming their competitive offer. It is clear from market dynamics that numerous banks are pitching teaser and other promotional offers at new (i.e. active/switching) customers precisely to attract such marginal customers, and that this practice is not limited to smaller or larger banks. For example, RBS often categorises customers as either "main banked" or not (and we note the CMA has itself tried to reflect this distinction in its own research based on the fact that this is a common internal approach for most banks).

RBS's new strategy since 2014, however, reflects a choice not that it is unable to discriminate between its actual or potential customers (i.e. between new and old, active and inactive), but that it is unwilling to so discriminate. As the CMA is aware from earlier submissions and the site visit, this is part of its rebuilding of trust and the emphasis on fairness both as a corporate value and a competitive differentiator from other banks. RBS would reject any characterisation that its focus on treating customers fairly is exploitative and focused on margin enhancement on the existing customer base.

[110] UIS at paragraph 99(b).

The Bank's focus on its current customers is indeed to build trust, improve the customer relationship with a service focus, and supply customers with more banking products, provided that additional products are in the customers' interest; it is not aimed at increasing margins per product. Moreover, as far as new customers are concerned, one of the key points underpinning RBS's focus on NPS of existing customers is not only to measure whether the Bank is delivering on its promise of service, trust and fairness, but to ensure the "promotion" to new customers, including by word of mouth recommendation.

3.2.4 TOH3: Barriers to entry and expansion leading to worse outcomes for customers

RBS notes that the CMA intends to publish WPs on the topic of barriers to entry to cover:

- case studies;
- regulation, IT systems and payments systems; and
- branches.

While a number of case studies have been published, RBS understands there are more to follow and will provide a response as appropriate to these papers to supplement its initial comments below.

(i) CMA's findings

RBS welcomes the CMA's over-arching finding – which goes to the heart of the Market Investigation – that there has been significant entry and expansion and more general development in the provision of PCA and SME banking services over the past five years.[111] RBS would also stress the very significant entry in the last 18 months to two years: the FCA has confirmed that 14 new banks have been authorised in the UK since 2013.[112] This trend appears set to continue, with an additional 20 in the pre-application stage, and this level of anticipated entry into the market will clearly need to be reflected in the CMA's assessment.

The level of recent entry, as well as anticipated future entry, reflects the overall lack of unnecessary barriers which may have given rise to an adverse effect on competition. In particular, for most potential barriers, the CMA's assessment correctly indicates that they (i) do not amount to a competitive impediment; and/or (ii) are properly viewed as falling within the remit of other sectoral regulators (and are in the process of being addressed by them). For a small number of other issues, where the CMA's views in the UIS are less final, RBS anticipates responding in more detail to the relevant WPs but also provide preliminary comments below.

(ii) Comments

(a) Issues not amounting to a competitive barrier in the context of retail banking

As noted in its IS Response, RBS agrees with the CMA's preliminary analysis indicating that the regulatory requirements of *authorisation* and compliance with *anti-money laundering regulations* do not amount to competitive barriers to entry or expansion (albeit more can be done to simplify AML procedures).

[111] UIS at paragraph 115.

[112] Speech by Martin Wheatley, CEO of the Financial Conduct Authority, delivered at the Future of Financial Services event in London on 2 June 2015, available at http://www.fca.org.uk/news/firms/regulation-supporting-vibrant-markets.

Likewise, within the CMA's category of *Natural or Intrinsic Barriers*, RBS agrees that *access to funding* and *IT systems* do not place limits to new entry or expansion. Indeed, in relation to IT systems, new entrants, unencumbered by legacy IT systems, are, if anything, at a competitive advantage relative to more established banks.

(b) Potential barriers falling under the jurisdiction of other sectoral regulators

As noted in the UIS, *capital requirements* and *payment systems* fall within the remit of the Prudential Regulation Authority (the "**PRA**") and the Payment Systems Regulator (the "**PSR**"), respectively. Of course, this is not to say that they are irrelevant to the CMA's assessment of barriers, and RBS welcomes the CMA's continuing inter-regulatory co-ordination. However, in both cases, a significant amount of work is ongoing to ensure that unnecessary competitive barriers do not arise.

In relation to *capital requirements*, as the CMA notes, the PRA has been active in ensuring a level playing field for new and more established banks,[113] in particular, relating to different methods of calculating relevant credit risk (i.e. whether the standardised approach or the IRB). While the standardised and IRB approaches may give rise to significantly different risk weightings for similar credits, that does not necessarily result in equally large differentials in capital requirements relating to those credits. In the first place, effective capital requirements are determined not only by reference to the risk-weighted capital framework but also by, *inter alia*, leverage ratio and the Bank of England stress testing framework (the 2014 stress test was applied only to the eight largest banks and building societies, and not to newer or smaller banks). Moreover, risk weights under the IRB are subject to a number of floors. The PRA has, for example, applied a "slotting" regime to commercial real estate credits, while the Basel Committee is consulting on a capital floor framework based on standardised, non-internal modelled approaches. In any event, RBS agrees with the CMA that the IRB approach does entail added costs, such as the development and maintenance of the model, and reflects capital buffers which larger banks are required to maintain, but which do not apply to new entrants.[114]

Likewise, in relation to *payment systems*, RBS's view that the current structure does not amount to an anti-competitive barrier is consistent with the lack of any evidence received by the CMA indicating inability on the part of new entrants to access payment systems either directly or through a sponsor bank. The PSR has recently issued its final terms of reference for a market review into the supply of indirect access to payment systems (29 May 2015), with the intention of publishing its interim report by January 2016, followed by a final report in May 2016. RBS will be co-operating fully with the PSR as this market review progresses. In the shorter term, RBS will be complying with the PSR's Specific Direction 1 (Access: Sponsor Banks) regarding the publication of clear and up-to-date information on the Bank's sponsor bank services, and is additionally participating in the industry activity to develop a Sponsor Bank Code of Conduct, in close liaison with the PSR. Further, RBS is supportive of the FPS initiative to stimulate the development of additional technical access options for indirect participants.

(c) Other potential barriers: branches and branch network

RBS reiterates that the branch network does not amount to a competitive barrier to entry or expansion per se. As the CMA's survey data demonstrates, customers place great

[113] UIS at paragraph 122.

[114] UIS at paragraph 121.

emphasis on quality of service – mostly in the form of suitable and appropriately trained staff – with branch networks merely being one (but not the only) way of customers accessing such staff.

Indeed, rather than a physical branch network, one of the main hurdles for challenger and established banks is the need to attract and retain such suitable staff, such as Relationship Managers for SMEs and certain PCA customers. RBS considers that the lack of such suitable and appropriately trained staff would impede the growth of a challenger bank regardless of its branch presence. As evidenced by the strategies of a number of recent entrants, a physical branch is not necessary for entry. Examples include Atom Bank, which is pursuing a digital only strategy, and Tesco Bank, which, despite having the potential to establish a very significant branch network using its existing grocery footprint, has indicated that it is primarily pursuing an online and telephone-based strategy. This, together with Tesco Bank's success in achieving considerable scale in certain products such as credit cards and personal loans, is a strong indicator that the importance of a branch network has significantly decreased with the increase in online and mobile banking. Rather, it is the customers' relationship with their bank (and their satisfaction with the bank based on this) which is a more important factor.

In this regard, RBS does not agree with the CMA's characterisation of Tesco's strategy as "*limiting its potential market*".[115] This does not appear to be borne out by the case study. Rather, the choice to focus primarily on online and telephone delivery channels is based on the fact that "*customer appetite for a direct (branchless) proposition is likely to grow.*"[116]

Of course, the fact that a branch network is not necessary for entry is not incompatible with the fact that for certain banks, a branch network remains highly relevant. For RBS (and consequently Williams & Glyn), branches are an important aspect of its strategic positioning, including as a result of the Bank's emphasis on service proposition.[117] However, as the CMA is aware from previous RBS submissions, RBS (as well as other banks) is in the process of resizing its branch footprint in an effort both to reduce costs and to focus more appropriately on customer needs, particularly in relation to online and telephone banking.[118]

Nor is it the case that, because branches remain important for a limited set of customers and circumstances, they amount to a strategic barrier. This is again evidenced by new entrants targeting a non-branch based distribution model (such as Tesco, Atom) and/or particular segments of the market (e.g. Handelsbanken). In addition, the limited circumstances in which branches are required continue to decline. At the account opening stage, technological developments are likely to overtake the need for identification and anti-money laundering checks to be carried out in person. Whilst some procedural barriers (e.g. planning permission in the event of conversion of use) do exist, and perhaps sensibly so, these impact (relocating) incumbents and new entrants alike, and RBS would suggest that, based on preliminary indications such as challenger growth and real estate site availability, there is no evidence of significant problems.

[115] UIS at paragraph 128.

[116] Tesco Bank case study, paragraph 58.

[117] [**confidential**]

[118] [**confidential**]

(d) Full service provision

RBS welcomes the CMA's acceptance that *full service provision* is not a prerequisite for successful entry.[119] Although RBS, like other large banks, offers a broad range of financial services to try to meet their customers' varied needs, this is only one business model and does not rely on PCAs or BCAs acting as some form of gateway. As noted previously, SME banking and PCAs make commercial sense on a stand-alone basis. Neither is cross-subsidised in order to cross-sell other products and, therefore, they do not represent a barrier to entry for challenger banks.

(e) Information asymmetry

In the UIS, the CMA notes that incumbent banks may be able to utilise data relating to their customers' usage and behaviours to make more informed commercial decisions and to cross-sell and respond to customers' needs more effectively, and that this may give the incumbents an advantage over competitors who do not have access to such information.[120] RBS considers that any perceived imbalance relating to access to information is being redressed by a number of initiatives.

RBS agrees with the CMA that (for PCAs) the midata initiative enables businesses to provide services informed by consumer information,[121] which effectively creates a level playing field by allowing a provider to access customer information, irrespective of whether the customer has an account with that bank.

Further, as noted by the CMA, credit reference agencies are working towards narrowing any perceived information gap in relation to creditworthiness, by providing lenders with a range of information about potential borrowers/customers.[122] The CMA has expressed concerns that limited access to credit information on the part of smaller and newer providers may constitute a barrier to entry or expansion in SME lending. However, the CMA also recognised that the recently enacted Small Business, Enterprise and Employment Act 2015 provides for the sharing of credit information on SMEs.[123]

All of the above initiatives contain measures aimed at improving the ability of challenger banks to access information which might previously not have been available to them.

4 Conclusion

RBS welcomes the CMA's apparent continuing focus on demand-side issues which, in RBS's opinion, lie at the heart of competition concerns in retail banking in the UK. Only by addressing these issues effectively will customer engagement be enhanced and the derivative concerns reflected in the CMA's TOH2 and TOH3 be dealt with fully.

However, meaningful solutions to such demand-side issues are particularly challenging to craft in a vacuum. RBS and other banks made some efforts in this regard in their SME undertakings proposal to the CMA at Phase I. The Market Investigation presents a unique framework within which the CMA, working with the banks, can design industry-wide initiatives to encourage enhanced engagement. RBS looks forward to the opportunity of

[119] UIS at paragraph 151.
[120] UIS at paragraph 155.
[121] UIS at paragraph 156.
[122] UIS at paragraph 156.
[123] UIS at paragraph 157.

working with the CMA in crafting these tools which RBS considers fully aligned with its broader corporate strategy of increased customer trust and satisfaction.

12 June 2015